

Rethinking Sports Wagering

MICHAEL C. MACCHIAROLA*

Against the backdrop of shrinking tax revenues¹ and growing deficits,² individual states and the federal government are becoming increasingly inventive in their efforts to fill budget gaps.³ Recently, the State of Delaware attempted to take advantage of one particularly creative technique aimed at closing a portion of its own expected shortfall.⁴ As one of only four states exempted from the 1992 Professional and Amateur Sports Protection Act (PASPA),⁵ Delaware approved a bill designed to

* Distinguished Lecturer, City University of New York. This article is dedicated to the memory of John Farrell, who made his living trading securities, but was tempted by a football teaser every now and again. This article is a private publication of the author and expresses only his views.

1. NAT'L GOVERNORS ASS'N & NAT'L ASS'N OF BUDGET OFFICERS, THE FISCAL SURVEY OF STATES 23(2009) [hereinafter FISCAL SURVEY] (observing that state revenues from all sources including sales, personal income, corporate income, and all other taxes and fees are below expectations in thirty-eight states); *see also* Jennifer Steinhauer, *New Year but No Relief for Strapped States*, N.Y. TIMES, Jan. 5, 2010, at A15 (observing that “[s]tate tax collections for the third quarter of 2009 showed a drop of 10.7 percent, the third consecutive quarter of double-digit revenue decline”); John Waggoner, *IRS Tax Revenue Suffers in Economy*, USA TODAY, May 27, 2009, at 3B (observing that “[f]ederal tax revenue plunged \$138 billion, or 34%, in April” 2009 versus April 2008); *see also* THOMAS P. DINAPOLI, COMPTROLLER’S MONTHLY REPORT ON STATE FUNDS CASH BASIS OF ACCOUNTING APRIL 2009, at Exhibit D (2009), available at <http://www.osc.state.ny.us/finance/finreports/cash/monthly/april09.pdf> (reporting General Fund receipts of \$4.8 billion for April, representing a 44% drop from the prior April, and \$239.1 million below the Comptroller’s April 28 projection).

2. *See, e.g.*, John McCormick, *Schwarzenegger Works Washington for Fix to His Budget Crisis*, BLOOMBERG BUSINESSWEEK.COM, Jan. 21, 2010, <http://www.businessweek.com/news/2010-01-21/schwarzenegger-works-washington-for-fix-to-his-budget-crisis.html> (describing the efforts of the California Governor to bridge his state’s \$19.9 billion deficit, and observing a \$193 billion deficit across all U.S. states).

3. *See, e.g.*, Lori Montgomery, *Once Considered Unthinkable, U.S. Sales Tax Gets Fresh Look*, WASH. POST, May 27, 2009, at A15 (suggesting that “some Washington policymakers are taking a fresh look at a money-making idea long considered politically taboo: a national sales tax”); *see also* Danny Hakim & Nicholas Confessore, *Patterson Seeks Huge Cuts and \$1 Billion in Taxes and Fees*, N.Y. TIMES.COM, Jan. 19, 2010, <http://www.nytimes.com/2010/01/20/nyregion/20budget.html?scp=1&sq=Patterson%20Seeks%20Huge%20Cuts%20and%20%241%20Billion%20in%20Taxes%20and%20Fees&st=cse> (describing the New York Governor’s efforts to find new sources of revenue from “legalizing mixed martial arts, allowing the sale of wine in grocery stores, taxing bottled soft drinks, taxing cigarette sales on Indian reservations and deploying speed-enforcement cameras in highway work zones” among other things).

4. *See* Chad Millman, *Behind the Bets: Jack Markell Is Ready to Legalize Sports Betting in Delaware. The Ramifications Across the Political Landscape Could Be Significant*, ESPN.COM, Mar. 10, 2009, <http://sports.espn.go.com/espnmag/story?id=3968082> (noting that the Delaware governor expects to bring in fifty to one hundred million dollars in revenue through betting on games against a projected seven hundred million dollar budget deficit).

5. 28 U.S.C. §§ 3701–3704 (2006). Oregon, Delaware, and Nevada were exempted from the Act because sports wagering was legal in those states at the time of PASPA and elimination

ensure its place as the first state east of the Mississippi to allow sports wagering through the implementation of a state-sponsored sports lottery.⁶ With sizable revenue to be realized, there should be little doubt that other states will follow Delaware's lead as soon as they can cultivate a game plan.⁷ Such a development should be embraced as

of preexisting activity was seen as too harsh a result. The "grandfathering" of these states is limited under the statute. Bill W. Bradley, *The Professional and Amateur Sports Protection Act—Policy Concerns Behind Senate Bill 474*, 2 SETON HALL J. SPORT L. 5, 9–10, 9 n.18 (1992) (describing the rationale for the grandfathering). See generally Thomas B. Colby, *Revitalizing the Forgotten Uniformity Constraint on the Commerce Power*, 91 VA. L. REV. 249, 250–52, 258 (2005) (describing the various activities of individual states that are beyond the reach of PASPA).

6. After Governor Markell sought an advisory opinion, the Delaware Supreme Court found that the proposed sports betting lottery did not violate state law. In re Request of the Governor for an Advisory Opinion, No. 150, 2009 WL 1475736 (Del. May 29, 2009); see also A.J. Perez, *Delaware State Senate Approves Sports Betting*, USA TODAY, May 13, 2009, http://www.usatoday.com/sports/2009-05-12-delaware-sports-betting_N.htm (noting that "[w]henver it's signed, Delaware will become the first state east of the Mississippi to allow sports wagering"). In a letter to the Delaware Supreme Court, the governor described the prospective sports lottery as having the following attributes: (a) being "under control of the state," (b) being "operated for the purpose of raising funds," and (c) being, "at all times, 'lotteries' within the meaning of that term" in the Delaware State Constitution, meaning "the outcome is determined by chance." Specifically, the state informed the court that it is contemplating one or more of the following games:

- (i) Single Game Lottery: Players must select the winning team in any given contest with a line.
- (ii) Total Lottery: Players must select whether the total scoring in a game will be over or under the total line.
- (iii) Parlay Lottery: Players must select the winning outcome on multiple elements, such as the winner of two or more games, the winner of two or more over-under bets.

Advisory Opinion, WL 1475736, at *1–*2.

7. There exists a reasonable argument that the current state of the law, exempting four states from the PASPA, is rather arbitrary. See Colby, *supra* note 5, at 262 (suggesting that the Supreme Court's support of a nonuniform application of the Commerce Clause power in the PASPA context is "directly contrary both to the original intent of the Framers and to the once-settled general understanding of the scope of the commerce power"). As more states look for alternative sources of revenue, it is likely that this status will be tested. See, e.g., Complaint and Demand for Declaratory Relief, at 18, 21, 26, *Interactive Media Entm't & Gaming Ass'n v. Holder*, No. CV-01301 (D.N.J. filed Mar. 23, 2009) (challenging PASPA on several constitutional grounds, including (1) as a violation of the uniformity requirement of the Commerce Clause, (2) on equal protection grounds, and (3) as a violation of the Tenth Amendment); Lesniak: *Let N.J. rake in millions via sports betting*, Jersey J. Mar. 24, 2009, at A3, available at <http://sports.espn.go.com/espn/news/story?id=4010970> (describing the lawsuit brought by New Jersey legislator Raymond Lesniak aimed at overturning the ban on state-sponsored sports wagering established by PASPA). Not to be outdone, the Chairman of the House Financial Services Committee, Representative Barney Frank (D-MA), has expressed a commitment to reintroduce legislation to regulate Internet gambling and ensure revenues that are currently lost to offshore gambling operators. The size and shape of the legislation remains uncertain. Eric Pfanner, *A New Chance for Online Gambling in the U.S.*, N.Y. Times.com, Apr. 27, 2009, <http://www.nytimes.com/2009/04/27/technology/internet/27iht-gamble.html> (noting that "[e]ven the most bullish advocates of online gambling acknowledge that Internet sports

forward thinking. And, the federal government should give serious consideration to assisting the states in their efforts.

Delaware's position has been dealt a significant setback in recent months, however, with the Third Circuit holding "that elements of Delaware's [proposed] sports lottery violate federal law."⁸ The Third Circuit's holding stems from a complaint and subsequent motion for preliminary injunction filed by several professional sports leagues challenging Delaware's proposed betting scheme as a violation of PASPA.⁹ The Third Circuit found that the single-game wagers proposed under the Delaware legislation exceeded the scope of the exception that PASPA shall not apply to "a lottery, sweepstakes, or other betting, gambling, or wagering scheme in operation in a State or other governmental entity, *to the extent that the scheme was conducted by that State* or other governmental entity at any time during the period beginning January 1, 1976, and ending August 31, 1990."¹⁰

In striking down the single-game bets proposed in the Delaware scheme, the Third Circuit accepted the interpretation of the sports leagues that the plain language of the statute doomed the Delaware law. The court stated that "it is not sufficient that a particular lottery may have been contemplated, or even authorized" by a state during the period prescribed by the statute, but rather, the court "must consider the specific means by which the lottery was *actually conducted*."¹¹ With such an interpretation, the Third Circuit effectively limited the type of sports wagering that Delaware could conduct to "multi-game parlays involving only NFL teams."¹² Because no single-game betting was conducted by Delaware during any time that triggered the PASPA exception, the court reasoned that the state is thus prohibited from instituting such a program today.¹³

betting—as opposed to poker or casino games—is highly unlikely to be legalized"); *see also* Ian Thomsen, *Stern Open to Legalized Betting, Rule Changes*, SI.com, Dec. 11, 2009, http://sportsillustrated.cnn.com/2009/writers/ian_thomsen/12/11/weekly.countdown/index.html (quoting NBA Commissioner David Stern as saying "[t]he betting issues are actually going to become more intense as states in the U.S. and governments in the world decide that the answers to all of their monetary shortfalls are the tax that is gambling.").

8. *Office of Comm'r of Baseball v. Markell*, No. 09-3297, 2009 WL 2710153, at *1 (3d Cir. Aug. 31, 2009).

9. PASPA specifically permits the commencement of a civil action to enjoin a violation "in an appropriate district court of the United States by the Attorney General of the United States, or by a professional sports organization or amateur sports organization whose competitive game is alleged to be the basis of such violation." 28 U.S.C. § 3703 (2006). After the district court set a trial date and refused to grant a preliminary injunction because the sports leagues failed to show a likelihood of success on the merits, the leagues appealed. On appeal, the Third Circuit decided the case on the merits, noting that "we need not decide whether the District Court's denial of the Leagues' preliminary injunction was proper because we hold as a matter of law that elements of Delaware's sports lottery violate federal law." *Office of Comm'r*, 2009 WL 2710153, at *1.

10. 28 U.S.C. § 3704(a)(1) (2006) (emphasis added); *see also* Colby, *supra* note 5, at 250 n.3 (describing the scope of the exceptions as applied to the activities of the individual excepted states).

11. *Office of Comm'r*, 2009 WL 2710153, at *7 (emphasis in original).

12. *Id.* at *9 (adding that "any effort by Delaware to allow wagering on athletic contests involving sports beyond the NFL would violate PASPA").

13. *Id.*

While the Third Circuit's approach finds ample support in the plain language of the statute, application of such a regime only serves to highlight the historically accidental nature of the sports wagering laws across the nation's fifty states.¹⁴ Clearly the Framers could not have intended—and no one can defend as fair or efficient—a system that allows casino sports book betting in Nevada,¹⁵ a sports-based lottery scheme in Oregon,¹⁶ a state sponsored multigame NFL lottery in Delaware,¹⁷ and constrains those states from expanding into similar activities while at the same time prohibits all forty-six other states from any sports wagering activity whatsoever.¹⁸

The recent efforts of the State of Delaware and the resulting Solomonian opinion of the Third Circuit only serve to put front and center an issue that has been glossed over for far too long.¹⁹ Namely, can Congress afford to sit idly by while—despite all of its efforts to eradicate sports wagering—the business of sports wagering flourishes in the nation's dark alleys and in the deep recesses of the Internet?²⁰ In fact, in America, sports wagering is now so prevalent that, his recent dalliances notwithstanding, “[a] significant and growing number of the millions of Americans who watch Tiger Woods tee it up on any given weekend are likely to have an economic interest in his performance.”²¹

14. See, e.g., Colby, *supra* note 5, at 250 (noting that “what is, or at least should be, eyebrow-raising is that this conduct violates *federal* law in some states, but not in others” (emphasis in original)).

15. NEV. GAMING. COMM § 22 (2008).

16. OR. ADMIN. R. 177-090-000 to -057 (2009).

17. *Office of Comm’r*, 2009 WL 2710153, at *9.

18. Colby, *supra* note 5, at 342 (observing that PASPA “regulates along state lines and exempts certain states from its scope, yet the problem that it addresses—sports gambling—is not ‘geographically isolated’” and noting that “[t]he only geographic distinction between the exempted states and the covered states was the variation in existing state laws at the time that Congress took up the issue”) (quoting Reg’l Rail Reorganization Act Cases, 419 U.S. 102, 159 (1974)).

19. See Millman, *supra* note 4 (observing that “[o]nce upon a time supporting any form of betting was considered one of the third rails of American politics,” but conceding that “that’s changed in the past fifteen years, as riverboat and Native-American casinos have become as ubiquitous as interstate exits”).

20. In fact, despite all of the efforts to eradicate sports wagering, annual estimates of the size of the market range from \$80 billion to \$380 billion. Koleman S. Strumpf, *Illegal Sports Bookmakers* 1, 46 (Feb. 2003) (unpublished manuscript, available at <http://www.unc.edu/~cigar/papers/Bookie4b.pdf>) (noting that “[t]he illegal market dwarfs the legal one”); see also Millman, *supra* note 4; cf. Nick Gillespie, *Paying with Our Sins*, N.Y. TIMES, May 20, 2009, at WK14 (suggesting the legalization of drugs, prostitution, and gambling and observing that “[i]n terms of economic stimulation and growth, legalization would end black markets that generate huge amounts of . . . activity that doesn’t contribute to increased productivity”); Frank Deford, *Gambling in Delaware Is a Sure Bet*, SI.com, May 27, 2009, http://sportsillustrated.cnn.com/2009/writers/frank_deford/05/27/delaware/index.html (asking “[w]hy would you be against letting folks bet legally rather than with the mob—especially in these parlous times?”).

21. Michael C. Macchiarola, *Securities Linked to the Performance of Tiger Woods? Not Such a Long Shot*, 42 CREIGHTON L. REV. 29, 29 (2008).

Despite Delaware's setback, with so many states in dire economic straits,²² harsh economic realities might overcome the moral overtones that have, for so long, controlled the debate around gambling.²³ While embracing some form of sports wagering might seem like a sea change, closer examination reveals that it might not be much of a change at all.²⁴ For the last half century, lotteries, slots, and Indian reservation casinos have become increasingly commonplace in America²⁵ and, as one commentator noted, "any attempt to distinguish categorically between investing and gambling is unprincipled and unworkable, and the prevailing regime predicated on that philosophy should be abandoned."²⁶ Indeed, recent financial market failures

22. FISCAL SURVEY, *supra* note 1 at vii (observing that "[t]he 50 states are facing one of the worst fiscal periods in decades"); *see also* Alex Johnson, *Budget Crises Swamp State After State*, msnbc.com, May 26, 2009, <http://www.msnbc.msn.com/id/30855847/> (noting that forty-eight of the fifty states "faced real-time or projected funding shortages during this budget cycle").

23. *See, e.g.,* Bradley, *supra* note 5, at 8 (characterizing, in hyperbole worthy of a United States Senator, the Senate's efforts in passing the PASPA as "the task of preventing what many members rightfully deem[ed] to be an evil affecting the nation at large"). With respect to sports wagering, the commissioners of the professional sports leagues have also established a fairly robust track record of opposition to wagering activity on "integrity of the game" grounds. Such attacks are largely anecdotal, however, and one court has noted that "there is . . . overwhelming evidence already reviewed that, in actual experience, widespread gambling, both illegal and state-authorized, has not hurt the NFL." *Nat'l Football League v. Governor of Del.*, 435 F. Supp. 1372, 1379 (D. Del. 1977); *see also* S. REP. NO. 102-248, at 14 (1993) (minority views of Mr. Grassley) (observing that "[t]he professional sports leagues have long been aware of extensive wagering on their games, have taken virtually no action to prevent it, have recently acquiesced in it, and, in fact, have benefitted from it"); Phil Sheridan, *Hypocrisy on Delaware Sports Betting*, PHILA. INQUIRER, May 19, 2009, at D1 (observing that "the NFL and the NCAA will put on a show of fighting the moral decline represented by the proliferation of legal gambling—even as both institutions reap enormous indirect benefits from deeply entrenched illegal gambling on pro football and big-time college basketball and football").

24. The appetite of states to coexist with gambling activity has been increasing in recent years. The State of Kansas, for example, has taken to owning casinos outright. John Hanna, *Conservative Kansas to Open—and Own—Casinos*, PHILA. INQUIRER.COM, Sep. 13, 2009, http://www.philly.com/inquirer/world_us/20090913_Conservative_Kansas_to_open_-_and_own_-_casinos.html.

25. For example, lottery revenue has become increasingly important for individual states. *See* Cletus C. Coughlin, Thomas A. Garrett & Rubén Hernández-Murillo, *The Geography, Economics, and Politics of Lottery Adoption*, 88 FED. RES. BANK ST. LOUIS REV. 165, 166 (2006) (noting that, in 2004 alone, forty-eight billion dollars were spent on lottery products, with states netting fourteen billion dollars in lottery revenue); Ryan D. Hammer, *Does Internet Gambling Strengthen the U.S. Economy? Don't Bet on It*, 54 FED. COMM. L.J. 103, 117 (2001) (observing that "legal gambling operations in the United States pay millions of dollars in taxes annually to local and federal governments"); Sheridan, *supra* note 23 (NBA Commissioner David Stern conceded that "[i]t's changed. . . . Gambling is the American way. Some 40-some-odd states have lotteries. Those that may or may not, they've authorized reservation gambling. Now it's the slots at racetracks, and more is coming.").

26. Christopher T. Pickens, *Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and Does It Even Matter?*, 14 GEO. MASON L. REV. 227, 229 (2006); *see also* Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to*

demonstrate the unworkable and impractical nature of this artificial line that exists between gambling and investing.²⁷ Today, few can argue that plenty of existing securities sold to retail investors are capable of far more pernicious effects on investors (or overall market stability) than simple sports wagers. Even fewer can foster a credible argument that sports contests lack the requisite level of transparency found in many of today's investment products.

Against such a backdrop, and with the goal of increased revenue for the state and federal coffers, it is high time that serious consideration be given to regulating sports wagers under the federal securities laws.²⁸ In fact, allowing sports certain wagers under the umbrella of the federal securities laws could (1) mitigate the effects of the accidental, arbitrary, clumsy, and unfair monopoly that currently exists for the four states exempted from the PASPA; (2) afford those individuals wishing to wager on their favorite sports team legitimacy and market protections that they do not currently enjoy;²⁹ and (3) provide politicians a rare opportunity to raise additional revenue without facing the political wrath that generally accompanies any increase in income, sales, or property taxes.³⁰

If our current economic lassitude fails to be the catalyst for the federal government to revisit the issue of sports gambling within the United States, the absurdity of the current patchwork highlighted by the recent Delaware case should be enough to promote change. This Article argues that there is a more rational—and more profitable—means to control sports wagering in this country. In other words, there's a better way to do sports wagering.

I. THE TRADITIONALLY DISPARATE TREATMENT OF GAMBLING AND INVESTING

Hostility towards wagering has had a long history in the law; gambling was generally viewed as providing no benefit to society aside from its entertainment

Love Risk, 100 COLUM. L. REV. 1096, 1135 (2000) (“[W]hile attitudes toward gambling have changed over the last hundred years, the basic problem of distinguishing legitimate risk allocation from illegitimate speculation is still alive and unsettled, and perhaps unsettling.”); see also Christine Hurt, *Regulating Public Morals and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox*, 86 B.U. L. REV. 371, 440 (2006) (“At a basic level, gambling and investing are identical activities of wagering on an outcome in an environment of uncertainty.”).

27. See, e.g., MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* 256 (2010) (noting, in the context of the recent crisis, that “[t]he line between gambling and investing is artificial and thin”).

28. Similar to the process surrounding a decision to adopt a state lottery, politicians are likely to weigh several factors in deciding the feasibility of any policy that legalizes any gambling activity. When faced with pressure to increase revenues, policymakers are likely to examine at least three alternatives: (1) increasing the rates of existing taxes, (2) expanding the universe of what is taxable, and (3) adopting and implementing new taxes. Macchiarola, *supra* note 21, at 81. It is also likely that financial institutions will embrace sports notes as an additional source of revenues and fees. *Id.* at 79–80.

29. See *infra* note 65 and accompanying text.

30. See, e.g., Thomas R. Klassen & Jim Cosgrove, *Look Who's Addicted to Gambling Now*, POL'Y OPTIONS, Jul.–Aug. 2002, at 43, 46 (describing “[t]he dramatic expansion of government-sanctioned, regulated and promoted gambling” in Canada as “a politically effective response to the demand by many citizens and lobby groups for tax cuts without spending cuts”).

value.³¹ Activities labeled “investing,” by contrast, have enjoyed a smooth ride, with policy makers encouraging “an enterprise of skill in which the assiduous and diligent may earn deserved rewards.”³²

At the federal level, the disdain for wagering has manifested itself in a series of statutory floggings of all things gambling. The patchwork of rules and regulations that muddied the landscape in this area began with the Gambling Devices Act of 1951,³³ which made it a crime to transport gambling devices across state lines to locations not specifically exempted by local or state law. The Wire Act³⁴ followed ten years later, making it illegal for a person, “engaged in the business of betting or wagering,” to transmit information through interstate wire facilities if the information assisted in the placing of bets or wagers.³⁵ In 1992, with thirteen states considering legislation to legalize state-sponsored sports betting, Congress passed the PASPA.³⁶ PASPA represented an outright ban on the expansion of state-sanctioned gambling on professional and amateur sporting events throughout the United States.³⁷ Finally, the Unlawful Internet Gambling Enforcement Act (UIGEA)³⁸ was passed by Congress in

31. Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 377 (2005); see also Macchiarola, *supra* note 21, at 32 (noting that “opponents often associate gambling with (i) an increased crime rate and the presence of organized crime, (ii) economic loss, (iii) gambling addictions which cost the government monies related to treatment and prevention, and (iv) *moral depletion* which instills the negative social value that money can be won without hard work” (emphasis in original)).

32. Hurt, *supra* note 26, at 373 (citing U.S. Securities and Exchange Commission, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, available at <http://www.sec.gov/about/whatwedo.shtml>).

33. 15 U.S.C. § 1175 (2006).

34. Pub. L. No. 87-216, 75 Stat. 491 (1961) (codified at 18 U.S.C. § 1084 (2006)).

35. *Id.* (codified at 18 U.S.C. § 1084(a)). In interpreting the “business of betting or wagering” element of the test, courts have consistently required that a defendant be a “bookie” (i.e., engaged in the business of receiving or taking bets), thereby limiting the prosecutions of gamblers under the Wire Act. *United States v. Tomeo*, 459 F.2d 445, 447 (10th Cir. 1972) (“The statute deals with bookmakers—persons ‘engaged in the business of betting or wagering.’” (quoting 18 U.S.C. § 1084)). In addition, courts have explicitly refused to apply the Wire Act to those simply acting as bettors. See *United States v. Anderson*, 542 F.2d 428, 436 (7th Cir. 1976); *United States v. Barborian*, 528 F. Supp. 324, 329 (D.R.I. 1981).

36. PASPA represented a Congressional attempt to eradicate sports gambling in America. By its terms, however, it should not prevent the issuance of a sports note. Congress’s actions were meant to preclude the individual states from sponsoring gambling on professional and amateur sporting events. No such activity is being proposed in this Article. In contrast, the sponsors of the proposed activity will be financial institutions operating as issuers or distributors of structured notes tailored to the investment tastes of clients.

37. 28 U.S.C. §§ 3701–3704 (2000) (describing specific state exemptions from PASPA); see also Anthony N. Cabot & Louis V. Csoka, *The Games People Play: Is It Time for a New Legal Approach to Prize Games?*, 4 NEV. L.J. 197, 208 (noting that PASPA marked a “radical departure from the historic policy that gambling laws were a state decision”).

38. 31 U.S.C. §§ 5361–5367 (2006 & Supp. 2009). The UIGEA specifically excludes from its reach any activities governed by the securities laws. 31 U.S.C. § 5362(1)(E)(i).

2006, prohibiting the transfer of funds from a financial institution to an Internet gambling site.³⁹

Today, it is PASPA that stands as the major roadblock to any efforts of the individual states to institute a sports lottery. Specifically, the legislation makes it unlawful for

a governmental entity to sponsor, operate, advertise, promote, license, or authorize by law or compact . . . a lottery, sweepstakes, or other betting, gambling, or wagering scheme based, directly or indirectly (through the use of geographical references or otherwise), on one or more competitive games in which amateur or professional athletes participate, or are intended to participate, or on one or more performances of such athletes in such games.⁴⁰

A complimentary provision of the statute makes it similarly unlawful for

a person to sponsor, operate, advertise, or promote, pursuant to the law or compact of a governmental entity, a lottery, sweepstakes, or other betting, gambling, or wagering scheme based, directly or indirectly (through the use of geographical references or otherwise), on one or more competitive games in which amateur or professional athletes participate, or are intended to participate, or on one or more performances of such athletes in such games.⁴¹

In a recent paper, I summarized the colossal failure resulting from the federal government's attempts to regulate sports wagering—traditionally the province of the individual states:⁴²

Despite this increased focus and intensity by the federal government—ultimately aimed at the outright eradication of sports wagering—gambling activities have only grown in popularity and acceptance, have filled the coffers of the unsavory elements of society, and have left gamblers exposed to a system that affords little in the way of protections. A new game plan seems long overdue.⁴³

In contrast to the skeptical eye that legislators have kept fixed on wagering activities, the government has chosen to regulate, rather than prohibit, activities that fall on the investment side of the divide.⁴⁴ The primary vehicle for this regulation is the federal securities regime embodied in the Securities Act of 1933⁴⁵ and the Securities and

39. The Act excepts fantasy sports, online lotteries, and horse/harness racing from its provisions. *See* 31 U.S.C. § 5362(1)(E)(ix), 10(B)(iii)(I).

40. 28 U.S.C. § 3702 (2006).

41. *Id.*

42. Cabot & Csoka, *supra* note 37, at 208.

43. Macchiarola, *supra* note 21, at 38; *see also* Sheridan, *supra* note 23 (“If anything, the legal obstacles to sports gambling serve mostly to give Las Vegas a monopoly—which is about as un-American an idea as you can imagine.”).

44. This choice, in large part, rests on the assumption that “[i]nvestment markets serve socially beneficial purposes.” Pickens, *supra* note 26, at 244. In light of recent events, it seems likely that some of these underlying assumptions will be revisited.

45. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a–77aa (2006)). The Securities Act was passed to provide investors with enough information to make sound

Exchange Act of 1934.⁴⁶ With such a robust preexisting structure regulating the offer, sale, and trading of products deemed investments, the path to permitting (and regulating) certain sports wagers has already been cleared.

II. THE CASE FOR REGULATING SPORTS WAGERS AS SECURITIES

As a threshold matter, applicability of the Securities Act and the Exchange Act is determined by whether the subject matter of the relevant transaction falls within the statutory definition of a “security.”⁴⁷ While the Securities Act and the Exchange Act both include the words “any note” within their definition of security,⁴⁸ a “workable test for determining when a ‘note’ should be considered a security eluded the courts”⁴⁹ until the *Reves v. Ernst & Young*⁵⁰ decision.⁵¹ In 1990, the *Reves* Court created a

economic judgments when purchasing securities and holding issuers liable for any misstatements or any other fraudulent activities in connection with the offering of securities. See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

46. Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78a–78nn (2006)). The federal securities law regime is a disclosure-based model based on the premise that (1) rules regarding disclosure indirectly influence corporate decision making and, therefore, encourage companies and their executives to behave more diligently and honestly; and (2) adequate disclosure ensures that investment decisions will be based on full and complete information. See Howell E. Jackson, *Regulation in a Multisectoral Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 345 (1999) (“The premise of all these mandatory disclosure rules is that in the absence of these rules investors would have inadequate information about the risks associated with particular securities”).

47. See 15 U.S.C. § 77a(c)(10). Section 3(a)(10) of the Securities Act defines the term security “in sufficiently broad and general terms so as to include . . . many types of instruments that in our commercial world fall within the ordinary concept of a security.” LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 231 (4th ed. 2004) (quoting Congressional Record at H.R. REP. NO. 73-85 (1933)). Also, the Exchange Act provides a slightly different definition of “security,” 15 U.S.C. § 77b(a)(1), which the Supreme Court has treated as essentially identical. *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975).

48. 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2006). As one commentator has noted, it is unlikely that Congress intended for the words “any note” to be read literally. Otherwise, the courts would be overwhelmed with personal contracts characterized as notes “without regard to diversity of citizenship or jurisdictional amount as a fraudulent ‘purchase’ of a ‘security.’” LOSS & SELIGMAN, *supra* note 47 at 234.

49. Janet Kerr & Karen M. Eisenhauer, *Reves Revisited*, 19 PEPP. L. REV. 1123, 1125 (1992).

50. 494 U.S. at 56.

51. In fact, prior to the *Reves* decision, the circuit courts had adopted four different tests to determine whether a note should be considered a security. Kerr & Eisenhauer, *supra* note 49, at 1125–29 (discussing the application of (i) the *Howey* test, (ii) the commercial/investment dichotomy test, (iii) the risk capital test, and (iv) the family resemblance test). Of these, the *Reves* Court embraced the “family resemblance” test favored by the Second Circuit. See generally Lynn T. Bursleson, Note, *When is a Note a Security? A Historical Perspective on the Supreme Court’s Adoption of the Family Resemblance Test: Reves v. Ernst & Young*, 24 CREIGHTON L. REV. 371 (1990).

rebuttable presumption that any note should be regulated as a security,⁵² and adopted a four-part inquiry, examining (1) the motivations of the buyer and seller, (2) the plan of distribution, (3) the reasonable expectations of the investing public, and (4) the presence of risk reducing factors.⁵³

In 2007, more than one hundred billion dollars of structured products—largely in note form—were issued in the United States.⁵⁴ These products continue to evolve in type but fit squarely within the “security” definition. In the typical case, a structured note allows an investor to make an initial investment in exchange for an issuer’s obligation to pay an amount at maturity. The amount due at maturity will usually depend upon certain contingent events and their magnitudes.⁵⁵ Thus far, the contingent events and magnitudes measured by structured notes have largely been limited to those expressed by some underlying security or securities (that is, the performance of the shares of IBM or a basket of technology stocks). This limitation is sensible in light of the most important pronouncement from the Securities and Exchange Commission (SEC or “the Commission”) with respect to these products. In a 1996 No-Action Letter, the SEC identified guidelines for the disclosure required in connection with a structured products offering.⁵⁶ Observing that the performance of the structured product “depends materially on” the market performance of the underlier, the Commission stated that investors must be furnished with information regarding the issuer of the underlying security in addition to the disclosure of the issuer of the structured product itself.⁵⁷ In a concession that paved the way for the exploding growth of this market, the Commission allowed for abbreviated disclosure regarding the underlying security “[w]here there is sufficient market interest and publicly available information” regarding the issuer of the underlier.⁵⁸ Recently, structured note issuers have tested the limits of the “sufficient market interest” test by designing products with

52. *Reves*, 494 U.S. at 65 (noting that “because the Securities Acts define ‘security’ to include ‘any note,’ we begin with a presumption that every note is a security”).

53. *Id.* at 66–67 (finding the note in question to be within the confines of the test and, therefore, a security).

54. Larry Light, *Twice Shy on Structured Products?*, WALL ST. J., May 27, 2009, at C1 (estimating U.S. sales at \$62 billion and \$105 billion for 2006 and 2007, respectively).

55. *Id.* (describing a structured product as “a contract in which the issuer, often an investment bank, promises to pay the purchaser specific payments in specific circumstances”). While there is no standardized definition of a “structured product” in the federal securities laws, several commentators have attempted a definition. *See, e.g.*, Mary Ann Gadziala, Assoc. Dir., Office of Compliance Inspections & Examinations, Sec. & Exch. Comm’n, SEC Speech at International Bar Association Conference: Structured Finance Activities: The Regulatory Viewpoint (Sep. 20, 2006), available at <http://www.sec.gov/news/speech/2006/spch092006mag.htm> (offering that “[t]hey have been described as securities that may be derived from or based on a particular security or commodity, a basket of securities, an index, a debt issuance, or a foreign currency”).

56. Morgan Stanley & Co., SEC No-Action Letter, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,256, at 77,293 (June 24, 1996).

57. *Id.* at 77,294.

58. *Id.* The resulting market practice has been to develop a structured product linked to a particular underlier and direct the structured product investor to the SEC reading room for the registration statement and the most recent periodic reports of the issuer of that underlying company.

returns based on the levels of various indices not simply comprised of publicly traded securities.⁵⁹

While it is abundantly clear that a structured product, regardless of the underlier it references, can be designed to fit squarely within the *Reves* “security” definition for purposes of the federal securities laws,⁶⁰ the question remains: should structured notes be available for investment with returns based on all contingencies and magnitudes under the sun, save sports scores? Moreover, in light of the Supreme Court’s pronouncement that “in searching for the meaning and scope of the word ‘security’ . . . form should be disregarded for substance and the emphasis should be on economic reality,”⁶¹ does such an inflexible regime make any sense?

Consider, for example, the following two hypothetical notes:

- It is well established in the market that Issuer A can issue a general, unsecured note representing its obligation to pay the noteholder at maturity. In purchasing the note, an investor (noteholder) can agree to pay the issuer \$1000 on the trade date in exchange for the right to a contingent payment at the note’s maturity. Further, the amount of the payment can vary based on the number of days during the note’s term that a particular market security (or, in parlance, “reference stock”) has a positive performance. If, for example, the reference stock has more positive return days than negative return days (that is, a positive “winning percentage,” if you will) the note can be designed to pay the investor \$1400 at maturity. If, on the other hand, the reference stock has as many or more losing days than winning days (i.e. at most a .500 “winning percentage”, if you will), the investor might receive \$600 from the issuer under the note’s terms.
- Issuer B might issue a general, unsecured note representing its obligation to pay an investor (noteholder) at maturity. In exchange for her \$1000 payment on the trade date, a noteholder might receive the right to a payment at the note’s maturity. In this case, the amount of the payment will be contingent upon the win-loss record of the New York Mets over the course of the upcoming Major League Baseball season. The note will pay \$1400 in the event that Jason Bay can lead his new team to a winning record, and \$600 in the event that the Mets fail to win more games than they lose.

Aside from the fact that the two notes can be made to be virtually indistinguishable from an economic perspective (other than their respective underlying and differing payout probabilities), the case for regulating a note contingent on the performance of a sports team (or basket of teams) in a manner consistent with the treatment of a similar product contingent on the performance of an individual market security (or basket of securities) is a simple one. Examining these notes against the *Reves* test, each should

59. See, e.g., Morgan Stanley, Pricing Supplement No. 508 to Form 424B2 (Feb. 1, 2008), available at <http://www.secinfo.com/dsVQx.t78.htm> (offering a product the return of which is based on the performance of the Baltic Dry Index, a number tracking worldwide international shipping prices of various dry bulk cargoes and issued daily by the Baltic Exchange).

60. For a more robust summary of the analysis supporting the characterization of these types of structured products as “securities” and the history of the Supreme Court’s holdings in this area, see Macchiarola, *supra* note 21, at 51–69.

61. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); see also *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

be classified as a security. In both instances, the issuer's purpose is to raise monies for its general use rather than to facilitate the sale of a minor asset or consumer good.⁶² By preparing an offering document and engaging in the selling efforts that generally accompany a structured product's offering (regardless of the underlier), each issuer clears the hurdle of the "common trading for speculation or investment"⁶³ and "reasonable expectations of the investing public"⁶⁴ prongs of the *Reves* test. Finally, with respect to the final part of the *Reves* inquiry—whether there are risk-reducing factors, including other regulatory schemes making the application of the securities laws unnecessary⁶⁵—there is no evidence that, prior to the adoption of PASPA, Congress intended to maintain sports wagers as beyond the reach of the federal securities laws.⁶⁶

62. This purpose becomes less certain, however, as the note's maturity becomes shorter. Therefore, there are additional considerations around allowing overnight or short-term wagers under such an infrastructure. Such issues are not discussed in this Article.

63. *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990) (quoting *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943)).

64. *Id.*

65. *Id.* at 67. This "comparable protection" rationale was applied in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 569–70 (1979) ("The existence of this comprehensive legislation governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans.") and in *Marine Bank v. Weaver*, 455 U.S. 551, 557–59 (1982) (holding that it is "unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws."). As Professor Coffee has noted, however, this approach "has come under severe criticism." JOHN C. COFFEE, JR. AND HILLARY A. SALE, *SECURITIES REGULATION: CASES AND MATERIALS* 328 (11th ed. 2009).

66. More likely, at the time of the enactment of the federal securities regulations, Congress seemed little interested in sports wagering, allowing issues of gambling generally to be settled at the state level under Tenth Amendment principles. Assuming that an issuer can qualify a sports note as a security for purposes of the federal securities laws, it will not endeavor to sell such a sports-style note unless it can hedge its economic exposure. In the context of the sports-style note, the issuer's hedging activities will differ from those employed for the standard structured note linked to a market security. In the securities context, the issuer of the structured note will most likely hedge by purchasing or selling the particular shares of the reference stock (or a related derivative product linked to those shares). In the sports note context, however, Issuer B will look to "hedge" its exposure to the fortunes of the New York Mets, most likely placing a bet at a casino that pays \$1400 if the Mets have more wins than losses and \$600 if they do not. In reality, the pricing that either issuer presents to a customer will be slightly worse than the pricing available to the issuer on its hedge. This way, the issuer is able to ensure a certain fee regardless of the fortunes of the underlying reference stock or the New York Mets. The process of hedging is far more complex than this simple example, and includes many different scenarios to minimize or eliminate both basis risk and credit risk. In "laying off" the issuer's risk by entering into a hedge, the Issuer B trader must be sure that her efforts steer clear of the Wire Act, avoiding having her hedging activity characterized as "a wire communication facility for the transmission of interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest" in violation of that Act. 18 U.S.C. § 1084(a) (2006).

CONCLUSION

While this Article does not mean to oversimplify a process that still requires much detailed analysis and legislative wrangling, it advances the notion that there exists an available path toward regulating certain types of sports wagers under the federal securities laws. Such an avenue should be given serious thought in light of our recent economic travails and the existing, ineffective patchwork of impotent federal regulation. Moreover, structured correctly, such a regime could benefit the investor; the issuing institution; the various sports leagues and teams; and the federal and state governments alike. Such a system could go a long way toward eliminating the arbitrary differences that exist among the states with respect to their ability to offer sports wagering within their borders. In addition, such a regime could provide the investor a predictable and stable product, along with the litany of protections that attach to all federal securities offerings.⁶⁷ Financial institutions, in turn, could benefit from both the

67. By regulating sports wagering in a manner consistent with a securities offering, an investor would bear the credit risk of a known financial intermediary with a credit rating and a track record of securities issuances. In the current framework, by contrast, gamblers generally face the credit risk of an unknown “bookie” on the other end of a telephone. In addition, the wagerer would benefit from the various remedies available under the Securities Act and afforded by the regulation of both the issuer and distributor of the structured note. In fact, a whole host of protections are afforded the investor. Section 11 of the Securities Act, for example, imposes civil liability if “any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” 15 U.S.C. § 77k(a) (2006). Section 12(a)(2) of the Securities Act provides an express private party cause of action for rescission of the sale of a security “by means of a prospectus or oral communication” that includes a material misstatement or omission. 15 U.S.C. § 77l(a)(2) (1988). Section 10(b) of the Exchange Act and the related Rule 10b-5 make it unlawful

for any person, . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2009). Section 17(a) of the Securities Act bars actions intended to defraud others in the “offer or sale of any securities,” including the making of false statements and material omissions. 15 U.S.C. § 77q(a) (2006). Finally, a broker-dealer makes an implied representation to each customer that it will deal fairly and in accordance with the standards that prevail in the marketplace. Under the reasonable basis suitability standard, a broker-dealer must have an “adequate and reasonable basis” for any recommendation. *In re F.J. Kaufman & Co.*, Exchange Act Release No. 34-27535, 45 SEC Docket 97 (Dec. 13, 1989) (quoting *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969)). The customer-specific suitability requirement imposes an affirmative duty upon a broker-dealer to make recommendations in light of an individual customer’s specific financial situation and level of sophistication. In addition to these traditional protections arising under the federal securities laws, the Financial Industry Regulatory Authority (FINRA) has provided specific guidance to its members in connection with the sale of structured products. *See, e.g.*, NAT’L ASS’N OF SECURITIES DEALERS, STRUCTURED PRODUCTS: NASD PROVIDES GUIDANCE CONCERNING THE SALE OF STRUCTURED PRODUCTS, 2005. Various industry groups have also offered “best practices” in the sale and distribution of these products to the

capital raised from the issuance of notes and the fees and commissions generated from their distribution. Sports leagues could benefit from licensing fees in connection with the products and might enjoy increased fan interest. The federal and state governments could see significant new tax revenues expand their coffers.⁶⁸ Finally, in the interest of full and fair disclosure, lawyers practicing in this area might realize some additional legal fees.

public.

68. By one estimate, commissioned by the plaintiff in the New Jersey lawsuit challenging PASPA, sports betting could grow to a ten billion dollar industry in New Jersey alone by 2011. While this study concerned potential sports wagering at casinos, racetracks and online (and did not specifically address wagering via structured products), it does, nonetheless, lend a certain credibility to the notion that the potential economic benefits to the states could be sizable. *See Lesniak: Let N.J. Rake in Millions Via Sports Betting*, JERSEY J. Mar. 24, 2009, at A3, available at http://pantagraph.com/news/article_ed053a52-a7f4-5641-916f-dad9e198991a.html.