Gambling Regulation: Lessons from the Securities Markets

(Testimony delivered by Professor David S. Ruder*, Northwestern University School of Law before the National Gambling Impact Study Commission, Chicago, Illinois, May 20, 1998)

It is a pleasure to appear before the National Gambling Impact Study Commission for the purpose of providing background regarding the federal regulation of the securities markets and presenting some lessons for gambling regulation that can be learned from securities regulation. As a professor of law who has been studying, teaching, and writing in the securities area for approximately 37 years and as a former Chairman of the United States Securities and Exchange Commission, I believe I am well qualified to present my observations and recommendations.

In summary, my conclusions are: 1) that additional disclosures should be made to prospective gamblers regarding the risks of gambling; 2) that those conducting gambling activities should be prevented from advertising to those who do not have the financial sophistication to understand the risks of gambling or do not have the financial ability to bear gambling losses; and 3) consideration should be given to finding other ways to protect those who are financially unsophisticated or unable to bear the risk of loss.

I. Similarities Between Gambling and Securities Markets

The definition of gambling contained in the National Gambling Impact Study Commission Act[1] is "any legalized form of wagering or betting conducted in a casino, on a riverboat, on an Indian reservation, or at any other location under the jurisdiction of the

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[1] Public Law 104-169; 104th Congress, 1996 Section 8

United States." Although clearly not intended to include activities conducted in the U.S. securities markets, the definition nevertheless is broad enough to include the purchase and sale of securities.

The securities markets and gambling share certain characteristics. Both involve uncertainty regarding outcome. For a gambler this uncertainty is frequently quantified as the odds that a certain bet will be successful. For an investor the uncertainty is whether the market will value the investment at a higher or lower level over time. Thus both gambling and investing involve risk. The primary distinction between gambling and investing is that an investor purchases an ownership right in a document that has underlying value (such as a share of stock in a corporation), while gambling merely involves the right to require another to meet an obligation to pay.

Both gambling and investing involve a variety of products. Gambling may involve many different activities, including card playing (e.g. Black Jack), dice throwing (e.g. craps), horse racing, and lotteries. Investing may involve the purchase or sale of many different securities, such as stocks, bonds, and complicated derivative securities.

Those participating in gambling and investing will invariably include persons who are financially able and sophisticated and those who are not.

Both gambling and investing are regulated, but while gambling regulation is primarily local in nature, investing is regulated primarily by the federal government, with state regulation providing important local adjuncts to the federal system. Given the risk based characteristics of both gambling and investing, the federal securities regulatory system offers some important lessons.

II. The Federal Securities Regulatory System — General

Since the passage of the Securities Act of 1933[2] regulating the distribution of securities and the Securities Exchange Act of 1934[3] regulating trading in securities, the U.S. government has developed an extensive regulatory system over the securities industry under the guidance of the Securities and Exchange Commission (SEC). Significantly, the Exchange Act refers not only to the "maintenance of fair and honest markets," but also to the need to "perfect the mechanisms of a national market system for securities."[4] Congress has recognized that the effectiveness of our capital markets depends upon fairness and lack of manipulation, but also has recognized that regulation designed to achieve those objectives should not unduly interfere with the operation of the capital markets.

The SEC regulates the distribution and trading of securities directly and with the assistance of self-regulatory organizations (SROs), primarily the stock exchanges and the National Association of Securities Dealers, Inc. (NASD). The SEC, the NASD, and the SROs regulate the activities of brokers and dealers. The SEC oversees the regulatory activities of the SROs by approving their rules, inspecting them, and occasionally imposing disciplinary sanctions on them.

The Securities Exchange Act of 1934 requires all brokers (persons engaged in the business of effecting transactions in securities for the accounts of others) and dealers

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[2] 15 U.S.C. & 77a-2 (1994) [Securities Act]

[3] 15 U.S.C. & 78a-11 (1994) [Exchange Act]

[4] Exchange Act, Section 2

(persons engaged in the business of buying and selling securities for their own accounts) to register with the SEC and to become members of the NASD or a securities exchange.[5] The SEC adopts rules governing the conduct of brokers and their associated persons, and the exchanges and the NASD also adopt rules relating to conduct of their members and their associated persons, including "registered representatives" who deal directly with the public.

One of the primary purposes of SEC and SRO regulation is to seek to assure that brokers dealing with the public are honest. This goal is also part of gambling regulation and securities regulations at the state level. The observations and recommendations presented below deal with three other areas of federal securities industry regulation: disclosure, the ability to understand risk, and the ability to bear the risk of financial loss.

III. Regulation of the Distribution of Securities - Disclosure

Several aspects of the securities laws regulating distribution of securities offer important insights for the gambling industry. When corporations sell securities to the public, they are asking investors to believe that future prospects for the corporation are good. The primary protection offered by the federal securities laws is disclosure, rather than evaluation of the merits of proposed investments. The theory is that once investors are fully informed they should be allowed to bear the risks and reap the rewards of their investment judgments.

The primary device used by the SEC to assure fair disclosure is to require that corporations selling securities to the public do so by use of a prospectus containing a full

[5] Exchange Act, Sections 15(a), 3(a)(4) and 3(a)(5)

description of the corporation and its purpose for raising funds. The disclosures must be complete, including descriptions of the corporation's business, property, and securities. The corporation must disclose the "risk factors" involved in the offering, including the following:

> [A] discussion of the principal factors that make the offering speculative or one of high risk; these factors may be due, among other things, to such matters as an absence of an operating history of the registrant, an absence of profitable operations in recent periods, the nature of the business in which the registrant is engaged or proposes to engage, or ... the absence of a previous market for the registrant's common equity.[6]

The disclosure protections of the securities laws provide a good model for gambling. Those conducting gambling activities should be required to make adequate disclosures about the risks of gambling, including a general warning about the risks of gambling and specific disclosure of the odds applicable to each form of gambling.

IV. Investor Sophistication

Despite the SEC's emphasis on disclosure as the primary means of protecting the public, it has promulgated rules and approved SRO rules designed to protect investors who are not financially sophisticated.

When corporations choose to sell securities without registering their securities with the SEC, they are able to utilize several exemptions. One of those exemptions is based upon the premise that certain so-called "accredited investors" do not need the

[6] SEC Regulation S-K, Item 503 (c)

protections of the disclosure resulting from the registration process. The assumption is that these investors are sophisticated enough to seek ample disclosure before investing and sophisticated enough to understand the significance of information disclosed to them. Accredited investors include officers and directors of the corporation whose securities are being sold, banks, and natural persons whose net worth exceeds $1 million.[7] In one of its exemptive rules the SEC recognizes that persons who are not accredited investors may also not be financially sophisticated, and requires that:

> Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and expertise in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment...[8]

This emphasis upon the ability to understand risk also provides a good model for the gambling industry. Those who conduct gambling activities should be prevented from directing advertisements to persons who do not have the sophistication to understand gambling risks. Consideration might also be given to restricting access by these persons to gambling establishments or to certain types of gambling activities.

V. Broker Regulation - Suitability

One of the primary protections for investors who are not able to bear the financial risk of particular investments is the "suitability" requirement. The NASD requires that their members and registered representatives deal fairly with customers[9] and also requires that in making recommendations to a customer, the member must have "reasonable

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[7] SEC Rule 501(a)

[8] SEC Rule 506(b) (2) (ii)

[9] NASD Conduct Rule IM -2310-2

grounds for believing that the recommendation is suitable for such customer" and must make reasonable efforts to obtain information concerning the customer's financial status, tax status, and investment objectives.[10] This suitability requirement is intended to prevent brokers from inducing customers to purchase securities that are too risky for them.

With regard to speculative securities, the NASD declares members' sales efforts to have exceeded the reasonable grounds of fair dealing if recommendations of speculative, low-priced securities are made to a customer without knowledge of or attempt to obtain information regarding the customer's other security holdings, financial situation, and other necessary data.[11]

The SEC has promulgated a series of rules dealing with "penny stocks," stocks that are not traded on a securities exchange or in the Nasdaq automated stock market and that have a value of less than $5.00 per share.[12] Because these stocks are usually risky investments sold through high pressure sales tactics, the SEC imposes a series of requirements designed to protect customers. One of them requires the broker to obtain from the prospective purchaser information concerning the person's financial situation, investment experience, and investment objectives[13], and to make a determination based upon that information that the transactions in penny stocks are suitable for that person. The broker must also determine that the customer (or the customer's independent advisor) has the capability of evaluating the risks of the transactions.[14]

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[10] NASD Conduct Rule 2310

[11] NASD Conduct Rule IM-2310-2 (b) (1)

[12] SEC Rule 3a51-1

[13] SEC Rule 15g-9 (b) (1)

[14] SEC Rule 15 g-9 (b) (2)

The NASD pays special attention to suitability recommendations regarding derivative instruments. According to the SEC:

> The term "derivative" is generally defined as an instrument whose value is based upon, or derived from, some underlying index, reference rate (e.g., interest rates or currency exchange rates), security, commodity, or other asset... Derivatives may be standard or customized, traded on an exchange or over-the-counter, liquid or illiquid, novel or familiar, leveraged or unleveraged.[15]

Although derivative instruments frequently are used to hedge risks and thus play a beneficial economic role, many of them are extremely complicated and difficult to understand. In 1996, the NASD published an interpretation intended to provide guidelines to brokers making recommendations to an institution regarding new types of instruments or instruments having significantly different risk or volatility characteristics than other investments generally made by the institution. The NASD defined an institutional customer for the purposes of its interpretation as any entity other than a natural person and indicated that its guidance was intended for those institutional customers with at least $10 million invested or under management.

Several significant points can be drawn from the NASD's interpretation. First, it confirmed that suitability requirements apply to institutional customers, even though such customers are generally regarded as sophisticated. Second, its guidance is intended to provide brokers with a "safe harbor" defense against charges of lack of suitability made by institutional customers. Third, this guidance is not made available to brokers dealing with non-institutional customers. Fourth, even with institutional customers, the broker is required to determine that the customer is capable of making independent investment

[15] Staff memo to the Chairman of the SEC. CCH Fed Sec. L. Rep. Par. 85,431, (Transfer Binder 1994)

decisions in general and also is required to determine whether the customer is able to understand a particular type of instrument or its risk. Finally, the broker is required to determine whether the customer in fact is making an independent investment decision with regard to the particular investment.[16]

Significantly, the NASD's efforts to provide protection to brokers engaged in selling complicated derivative products is limited to situations involving sales to institutional investors. Presumably many individual investors may not be financially able to bear the risk of derivative instruments or be capable of understanding that risk, so that the NASD's safe harbor interpretation is not available to brokers dealing with them.

Consideration should be given to requiring gambling sponsors or entities attempting to persuade others to engage in gambling activities to refrain from directing advertisements to potential gamblers who are unable to bear the financial risk of gambling losses. Consideration should also be given to restricting access by those persons to gambling establishments or to certain kinds of gambling.

VI. Exchange Traded Options

Special disclosure and suitability regulations imposed by the SEC and the SROs regarding exchange traded options provide a good example of regulation combining disclosures, sophistication requirements, and suitability requirements when the security has complicated characteristics. An option is a right either to buy or to sell a specified amount or value of a particular underlying interest at a fixed exercise price by exercising the option prior to its specified exercise date. For exchange traded options, the SEC

[16] NASD Conduct Rule IM-2310-3)

requires that each exchange prepare and file with the SEC an "options disclosure document" that contains the following information: a glossary of terms, the mechanics of options, the risks of trading options, the market for the options, and other matters.[17] The rule further provides that no broker may accept an order from an options customer unless the broker first furnishes the option disclosure document to the customer.

The options disclosure document prepared by the five U.S. options exchanges is a 98-page pamphlet.[18] Its risk disclosure chapter covers 31 pages and treats subjects such as: risks of option holders and writers; risks of index options; risks of debt options; risks of foreign currency options; risks of flexibly structured options, and other risks, such as combination options.

The NASD has special suitability requirements for options transactions that prohibit recommendations for such transactions unless the recommended transaction is "not unsuitable" for such customer and unless the customer may reasonably be believed to be capable of evaluating the risks of the recommended transaction and is financially able to bear the risks of the recommended position.[19] Special supervisory responsibilities for options transactions are assigned to registered options principals in each firm.[20]

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[17] SEC Rule 9b-1

[18] Characteristics and Risks of Standardized Options, American Stock Exchange et. al., February 1994, with 1995 and 1996 Supplements

[19] NASD Conduct Rule 2860(b)(19)

[20] NASD Conduct Rule 2860(b) (18)

IX. Summary and Recommendations

As noted in this testimony, gambling and investing share several common elements: 1) both activities involve elements of risk that are not within the control of the participants; 2) gambling and investment products by nature require disclosure in order to be well understood; and 3) persons engaged in gambling and investing will have varying degrees of financial sophistication and ability to bear the risk.

Congress, the SEC, and the SROs have responded to the needs to protect investors by establishing a regulatory regime that includes strong supervision over the securities industry, disclosure regarding investment risks, and in some instances prohibitions against recommending speculative or especially risky securities to investors who do not have sufficient financial sophistication and financial ability to absorb risk.

The public interest would benefit if some of the lessons from the securities industry were applied to gambling in order to prevent undesirable economic injury to those who gamble.

1. At the minimum, those conducting gambling activities should be required to make adequate disclosure regarding the risks of gambling. Disclosure should include a general warning about the risks of gambling and specific disclosure of the odds applicable to each form of gambling.

2. Those conducting gambling activities should be required to refrain from directing advertisements to prospective gamblers who do not have the financial

sophistication necessary to understand gambling risk and the financial ability to bear gambling losses.

3. Consideration should be given to finding other ways to protect those who are either financially unsophisticated or unable to bear the risk of loss, such as by restricting access to gambling establishments or access to certain kinds of gambling.