WANTED: Regulatory Reform "…So what does this law require?"

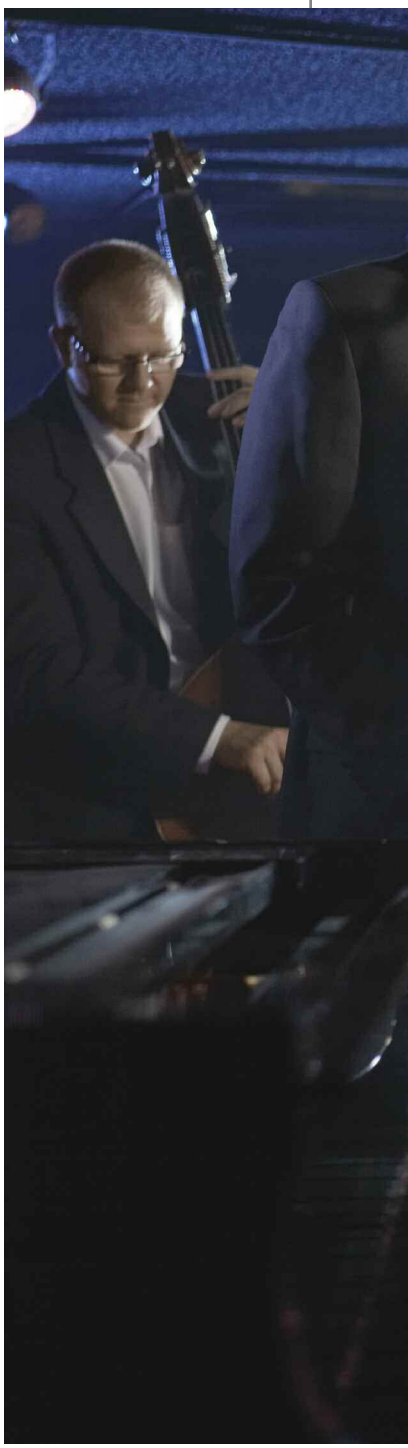
By Lou Dorn

Gaming practitioners often claim that they represent clients that operate in one of the most regulated industries in the world, which is certainly justified when examining the myriad of statutes and regulations that govern gaming in Nevada. However, the real challenge for such practitioners is providing their clients with accurate advice in light of the many regulations that are extremely vague, subjective and outdated. The challenge is not any easier for the regulators charged with implementing statutes and regulations that could have multiple interpretations. This article examines a handful of such regulations and suggests certain changes that may help practitioners and regulators alike fulfill their respective obligations.

Live Entertainment Tax

Ever since the live entertainment tax ("LET") was originally passed in 2003, the gaming industry and the Nevada Gaming Control Board ("GCB") have struggled with a number of its vague and undefined provisions. Recent efforts by the Nevada Legislature to pass significant changes to the LET statutes have been unsuccessful. While wholesale changes may in fact be on the horizon, the industry cannot continue to operate with such enormous ambiguity, and certainly cannot hope for statutory changes that may never come.

For example, many casinos, nightclubs and lounges employ the use of dancers to enhance the atmosphere of a particular area or venue, but have a difficult time knowing when such dancing triggers the LET. Pursuant to NRS 368A.090(2)(b)(8), dancing is considered an "occasional activity" that is excluded from the definition of "live entertainment," if such dancing (i) does not constitute a performance, (ii) is not advertised as entertainment to the public, (iii) primarily serves to provide ambience to the facility, and (iv) is conducted by an employee whose primary job function is not that of an entertainer. There are a number of problems with this exclusion, the most glaring of which is its failure to specify the length of time that a dance routine would be considered "occasional." If these employee-dancers perform for 20 minutes, serve drinks for 20 minutes, and then take a break for 20 minutes, did they provide "live entertainment" or was their dance routine considered an "occasional activity?" In addition, the exemption does not apply to a "performance," but provides no guidance as to what constitutes a "performance." Presumably, the dancing allowed by this exemption must be relatively inconspicuous and conducted by amateurs, because if the GCB determines that a particular dance routine was a "performance" or if the employee is primarily an "entertainer," then the venue may owe LET for every single drink and food item sold during such dance routines. Curiously, a very similar exemption is found in the same definition of "live entertainment" at NRS 368A.090(2)(b)(3), which exempts "occasional performances by employees whose primary job function is that of preparing, selling or serving food, refreshments or beverages to patrons, if such performances are not advertised as entertainment to the public." Both the (2)(b)(8) and (2)(b)(3) exemptions apply to "occasional" activities by "employees" that are "not advertised as entertainment." While similar in these respects, these exemptions also differ in peculiar ways. The exemption under (2)(b)(3) expressly allows such activity to be a "performance," whereas the (2)(b)(8) exemption is lost if the activity is a "performance." Also, the (2)(b)(3) exemption is more limiting in that it only applies to those employees that prepare, sell or serve food or drinks, whereas the (2)(b)(8) exemption covers any employees, such as dealers that occasionally perform. These are two completely separate exemptions seemingly covering similar activities, which scream out to the Nevada Gaming Commission ("NGC") for some clarification as to which exemption applies to what specific activity. At a minimum the NGC should consider adopting a regulation that further defines an "occasional activity," which provides for a specified number of minutes per hour that the activity may continue in order for such activity to be considered "occasional." In addition, one exemption applies to "performances" whereas the other does not. Once again, the gaming licensee is left to wonder what exactly constitutes a "performance" in the opinion of the GCB. Moreover, any such analysis in this regard necessarily defies logic because an employee whose job is to occasionally dance in a venue is certainly not doing so to exercise, but to entertain the venue's customers and therefore no doubt "performing" to some degree. Thus, the NGC should consider a regulation defining the "performance" referenced in the (2)(b)(8) exemption as a ticketed event presented to a captive audience from a stage and within the confines of a showroom or similar venue; while recognizing that the legislature intended to cover performances in a more general sense in reference to the (2)(b)(3) exemption because employees don't generally perform in showrooms.



Yet another provision, again among the same tortured attempt to describe activities excluded from the definition of "live entertainment," similarly excludes, "Performances in areas other than in nightclubs, lounges, restaurants or showrooms …

which enhance the theme of the establishment or attract patrons to the areas of the performances, as long as any seating provided in the immediate area of the performers is limited to seating at slot machines or gaming tables." NRS 368A.090(2)(b)(4). This provision more directly applies to "performances" on or near the casino floor, although not limited to "occasional" performances by "employees." Thus, presumably those performances that failed to qualify for the exemptions under NRS 368A.090(2)(b)(3) or (2)(b)(8) may find shelter under this exemption. However, once again, ambiguity permeates this provision, because now the gaming licensee will struggle to determine when seating at slot machines or table games is considered to be in the "immediate area" of the performers. As anyone familiar with the layout of casino floors can attest, there are numerous configurations of open areas with entertainment; some with bars that have slot machines, some with bars that don't have slot machines, and yet others that are simply in or around the gaming areas. Any effort to identify which seats at slot machines or table games are in the "immediate area" of these performers will undoubtedly produce varying results. Moreover, the applicability of the LET to casino bars and floors where drinks are being served all day and night would create a massive tax liability that the Nevada Legislature was clearly seeking to avoid. The NGC should consider a broad definition clarifying that this provision was intended to exclude any entertainment provided on or around a casino floor and define "immediate area" to mean any seating at slot machines or table games that provide an unobstructed view of the performer. The provision already excludes nightclubs, lounges, restaurants or showrooms, thus there should be no concern that a more broadly stated definition would inadvertently exclude live entertainment that is otherwise taxable.

Another area of frequent consternation is determining when ambient or background music in a restaurant or lounge might be considered "live entertainment" pursuant to NRS 368A.090(2)(b)(1). In order to qualify for the (2)(b)(1) exemption, the instrumental or vocal music must not "routinely" rise to the volume that interferes with "casual conversation" and does not "cause patrons to watch as well as listen." Gaming licensees and the GCB have struggled to find any consensus as to when such music "routinely" rises to such levels, or how to apply the highly subjective standards of "casual conversion" and when music "causes" patrons to watch and listen. This exercise in futility can be avoided by simply applying the LET exemption set forth in NRS 368A.200(5)(q), which more broadly provides that LET does not apply to "Live entertainment provided in a restaurant which is incidental to any other activities conducted in the restaurant or which only serves as ambience so long as there is no charge to the patrons for that entertainment." The connection between these two provisions is unusual - suggesting the drafters addressed the topic in one place after forgetting they already covered it elsewhere. A significant difference

is that one provides an exemption from the definition of "live entertainment," whereas the latter sets forth the circumstances upon which any "live entertainment" simply does not trigger the tax. In order to qualify for the LET exemption pursuant to NRS 368A.200(5)(q), the type of entertainment is not relevant. It doesn't matter because this exemption from the LET applies to any live entertainment, thereby including such instrumental or vocal music that otherwise failed to qualify for the (2)(b)(1) exemption. In other words, the restaurant in question merely needs to show that its live entertainment (in whatever form) is (i) incidental to other activities in the restaurant or only serves as ambience and (ii) and is free to its patrons. This standard may be a little easier to apply because it is not constrained by the highly subjective elements of the (2)(b)(1) exemption. The problem, however, is that the GCB has compelled licensees to prove the applicability of the (2)(b)(1) exemption, when such evidence is unnecessary given the more broadly stated and slightly less ambiguous provisions of NRS 368A.200(5)(q). The NGC should step in and put an end to the enormous waste of time and money the industry is expending on applying the (2)(b)(1) exemption. Instead, the NGC simply needs to adopt regulations clarifying when live entertainment in a restaurant is "incidental" or when its serves only as "ambience," and expressly provide that if such standards are satisfied, then the tax doesn't apply and any further analysis pursuant to the (2)(b)(1) exemption is unnecessary. If such live entertainment does not qualify as "incidental" or as "ambience" pursuant to whatever definitions that might be adopted by the NGC, then it likely would not fit within the (2)(b)(1) exemption anyway.[1]

Publicly Traded Corporations

The current practice for privately held gaming companies, whose ownership is indirectly held by a large number of passive investors, is for the company or its parent entity to voluntarily register its equity securities with the Securities and Exchange Commission ("SEC") by filing a Form 10. By doing so, the company qualifies as a "publicly traded corporation" as defined by NRS 463.487(1)(a)(1) and becomes subject to the reporting requirements of the Securities Exchange Act of 1934. These companies are referred to as "Form 10 Companies," and while they are privately held, they are regulated by the GCB as public companies pursuant to NGC Regulation 16. This approach has provided an avenue for such companies to invest in Nevada gaming operations without requiring the licensure of numerous indirect passive owners, such as pension funds and private equity investors, who have no intention of being involved in the gaming operations. The GCB and NGC have relied on the fact that while Form 10 Companies are privately held, they are required to file the same periodic reports that are filed by companies that are publicly traded. Therefore, as the argument goes, the GCB and NGC maintain the same level of regulatory oversight that they have over all public gaming companies. Much emphasis has been placed on this latter point, despite the fact that most (if not all) of the regulatory control over Form 10 Companies is actually embodied in their Orders of Registration. The Order of Registration is an order issued by the NGC that reflects a Form 10 Company's various licenses and approvals, but more importantly, imposes a number of conditions, limitations and restrictions that essentially incorporate the same regulatory controls otherwise applicable to private companies. Thus, while technically (literally) qualifying as a public company, a Form 10 Company is already regulated much like a private company.

With the foregoing as a background, the time has come to revisit this practice. Form 10 Companies are not large publicly traded companies, but rather much smaller companies that often only operate a single

casino. The only reason these private companies go through the onerous process of registering with the SEC is because the alternative is simply not possible. Many such companies are capitalized with private investment from large investment funds, which themselves have thousands of individual investors, making it impossible or impractical for every such individual to be licensed as an indirect owner. The process of registering with the SEC and maintaining compliance with the rigorous reporting requirements is very expensive and time consuming. Form 10 Companies are required to file annual reports on SEC Form 10-K, quarterly reports on SEC Form 10-Q, current reports on SEC Form 8-K, ownership reports on Forms 3, 4 and 5, and respond to periodic inquiries from the SEC. Periodic filings with the SEC must also be reviewed in detail by an external audit firm for compliance with hundreds of accounting standards and practices. Maintaining the status as a reporting company further requires such companies to utilize expensive SEC counsel to ensure all filings are compliant with the vast number of rules and regulations. While this alternative certainly opened some doors to the Nevada gaming market, the cost and effort of doing this has still dissuaded various investors and added an unnecessary financial strain on gaming companies that are already operating under tight budgets. In addition, single property gaming companies that are required to file periodic reports places them in a competitive disadvantage, requiring them to publicly disclosure financial information to competitors.

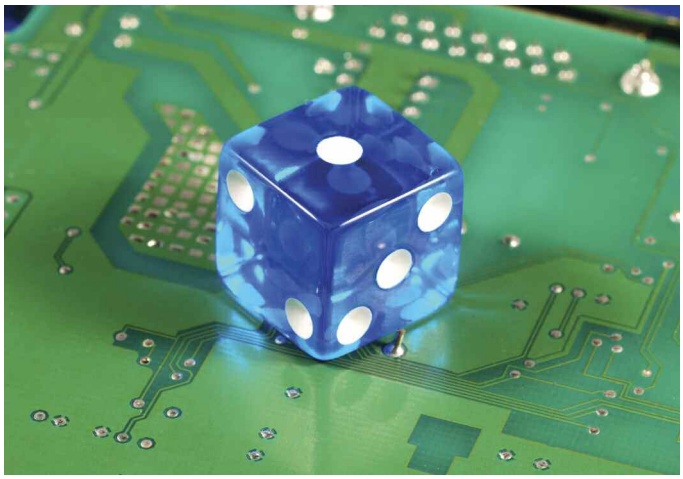
The problem lies with the current requirement that all owners of a private holding company must be either licensed by the NGC or register with the GCB, depending on whether they own more or less than 5% of the holding company. *See* NGC Regulation 15.585.7-4, 15A.190 and 15B.190. The following hypothetical helps illustrate this issue: Casino Group, LLC is licensed to conduct nonrestricted gaming operations, and its sole member and manager is Holdings, LLC. Holdings, LLC is owned by three different LLCs: PE Funds, LLC – 33.3%, Investor A – 33.3% and Investor B – 33.3%. Investor A and Investor B are individuals that control the gaming operations and of course must be licensed. PE Funds, LLC is a private equity fund that separately manages hundreds of millions of dollars for thousands of individual investors, banks, non-profit organizations

and pension funds, and which invested a small portion of its overall assets in this casino operation. Pursuant to gaming statutes and regulations, PE Funds, LLC is a limited liability holding company, which will require every one of its thousands of direct and indirect individual investors to either register or be licensed. The regulations applying to private holding companies make no distinction as to whether the "owner" has any voting or other control over the company. An "owner" could be someone that has a small balance in a pension fund and has no idea that the pension fund manager has invested some of its assets in PE Funds, LLC. It is simply not possible to obtain the registration of, or even locate, every single "owner" of PE Funds, LLC, and therefore there is no way the capital structure of Casino Group, LLC can be licensed in Nevada unless it or Holdings, LLC becomes a Form 10 Company.

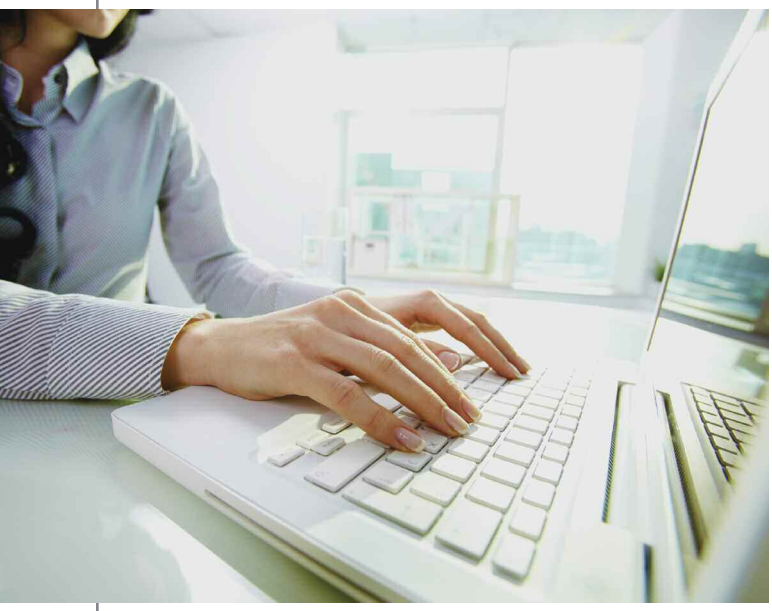
The good news is that all this can be easily fixed by the NGC, without any need for legislative action. The Nevada Legislature has already delegated this authority to the NGC pursuant to NRS 463.585(2). The NGC merely needs to modify the regulations applicable to private holding companies to adopt the same concept already applicable to public companies. As recognized by the regulatory scheme in NRS 463.643 and NGC Regulation 16.405, it is impossible to license every shareholder of publicly traded companies. These provisions instead focus on licensing only the "beneficial owners of voting securities." In the realm of gaming control over publicly traded companies, which by definition includes Form 10 Companies, the holders of non-voting securities are not subject to any mandatory licensing or registration requirements. A typical Form 10 Company will bifurcate its equity securities into voting and non-voting units, so that only the holders of the voting units are subject to licensure, and the passive investors, like PE Funds, LLC in the above example, would only hold non-voting securities. They would still enjoy all the economic benefits of their investment, and as passive investors, never sought control over the gaming operations in the first place. Thus, if the NGC simply modified NGC Regulations 15, 15A and 15B to require only the licensure of those "owners" of voting securities issued by a holding company, then a private holding company like Holdings, LLC in the above example would not be forced to go through the arduous and expensive process of becoming a Form 10 Company, which seems pointless from a regulatory control standpoint because such companies are already regulated much like a private company anyway. Despite some belief to the contrary, there is very little if any additional regulatory control gained over companies that are required to file periodic reports with the SEC, such as a Form 10 Company, over those that never needed to go through the process to begin with. Periodic reports are public documents and contain financial and other information that is either already provided to the GCB or can be required through additional conditions placed on the registration of a private holding company.

Service Providers

In 2011, the Nevada Legislature passed S.B. 218 (codified at NRS 463.677), which provided the NGC with enabling legislation for the licensure of "service providers." Pursuant to NRS 463.677(5)(b), a "service provider" is defined as (i) an "interactive gaming service provider" (as further defined by the statute); (ii) a "cash access and wagering instrument service provider;" (iii) a person who acts on behalf of a nonrestricted gaming licensee and who assists, manages, administers or controls wagers or games, or maintain or operates the software or hardware of games on behalf of the licensee, and is authorized to share in the revenue from such games; or (iv) a person who meets such other criteria as the NGC may establish by regulation. In December 2011, the NGC adopted the regulations called for by the aforementioned legislation and created several additional categories of "service providers" that must be licensed. Generally, these regulations were



components of the overall regulatory framework surrounding online gaming, or "interactive gaming," and were intended to capture key participants in the development of interactive gaming.



Among the additional categories of "service providers" created by the NGC was an "information technology service provider," which is defined as "a person who, on behalf of another licensee, provides management, support, security, or disaster recovery services for board regulated hardware of software." This was a curious inclusion and possibly an example of the regulatory net being cast beyond its intended targets. The reference to "board regulated hardware or software" includes all software approved as associated equipment pursuant to NGC Regulation 14. Manufacturers of such associated equipment are not subject to mandatory licensure. NRS 463.665. However, every manufacturer of such associated equipment provides "support" for their software, and it is common for gaming operators to sign software license and support agreements with these manufacturers. Thus, the inclusion of the word "support" in the definition of an "information technology service provider" inadvertently captures every single manufacturer of associated equipment and requires every one of them to be licensed as a "service provider." Of course, this is not what the GCB is currently requiring as that was not the intended reach of this regulation. Nevertheless, the gaming industry remains somewhat in the dark as to what type or level of "support" offered by a manufacturer of associated equipment will trigger licensure. Either the GCB should issue a notice to the industry explaining how it interprets this regulation, or the NGC should amend the regulation to more clearly capture only its intended targets.

A number of additional regulations could be addressed in this article, but that would require several more pages to cover. For example, it may be time to abolish NGC Regulation 14.025 as outdated and unnecessary, which was never supported by any evidence that certain "kiddie" themed slot machines are more attractive to minors than any other slot machine with animated graphics. On a different topic, the definition of "incidental to the primary business" as referenced in NGC Regulation 3.015, is a controversial topic and was addressed by the Nevada Legislature in 2013. However, despite the fact that slot parlors have never been legal in Nevada, the NGC remains reluctant to acknowledge the proliferation of slot parlors disguised as "taverns" in this state and that gaming is clearly not "incidental to the primary business" of these pretend taverns. In any event, regulatory control over gaming in Nevada will always be a moving target, and the GCB and NGC have maintained a progressive policy of revisiting outdated regulations and revising ambiguous provisions. Such regulatory framework has often been called the "gold standard" of gaming control by other jurisdictions, which can only be maintained by continually improving various regulations and providing the industry with more substantial, searchable regulatory intent.

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[1] The GCB held a workshop on May 7, 2014 regarding possible amendments to the regulations applicable to LET. One of the items addressed was whether regulations should be adopted to provide for the disposition of over-collected LET. No such regulations are necessary because NAC 368A.520 already clearly provides that claims for refunds of LET are handled like any other claim for refund pursuant to NRS 463.387.