

5 July 2010

To the Chairperson/Chief Executive

Key Messages from The Southern Trust (GC10/10) and The Trusts Charitable Foundation (GC11/10) Gambling Commission Appeals

Purpose

This letter clarifies the Department's expectations in relation to actual, reasonable and necessary costs; minimising costs and maximising net proceeds; venue developments and enhancements and a number of other issues following recent Gambling Commission appeals.

Comment

In May 2010 the Gambling Commission (the Commission) issued decisions on respective appeals by The Southern Trust and The Trusts Charitable Foundation. The Southern Trust was suspended for five days after it had incurred development and enhancement costs without reference to limit C, incurred unnecessary costs in upgrading gambling areas, and incurred substantial brokerage costs to secure two new venues. The Trusts Charitable Foundation was suspended for six days after incurring unnecessary society costs through third party entertainment and contracting a party to find new venues.

The Commission has provided several key messages in the decisions which impact on how societies must conduct their operations. These messages reiterate the key themes and duties in the Gambling Act 2003 (the Act) and provide other guidance on how societies should operate. These messages are outlined below. Please read them carefully.

Actual, Reasonable and Necessary Costs

By virtue of the definition of "net proceeds" in the Act, societies may only incur costs that are actual, reasonable and necessary in conducting gambling and complying with statutory requirements and licence conditions. The term "conducting gambling" is defined in the Act.

As noted by the Commission, any costs incurred that do not meet this test are, by definition, net proceeds and subject to the obligation of application or distribution. A failure to apply or distribute net proceeds is an offence under section 106 of the Act. The effect of a summary conviction under this section is the automatic loss of the class 4 operator's licence without a right of appeal.

The Commission has stated that, in its view, "necessary" defines whether a cost may be incurred at all, and "reasonable" defines its quantum. That is, once a society has determined a cost is "necessary", it must then turn its attention to whether the amount being incurred is reasonable.

The Commission, in quoting the Court of Appeal, has stated that "necessary" is a "fairly strong word falling between expedient or desirable on the one hand and essential on the other". Whether a cost is necessary or not to conducting gambling or legal compliance is a question that societies must consider with respect to every cost incurred.

Indeed, the Commission noted in one of the appeals that the expenditure had been incurred without an "item by item necessity analysis" which could be appraised and that, "in order to discharge its obligations, such an appraisal was required". The message is clear that societies must be able to justify every cost incurred.

This is an obligation that rests with societies. The Commission has stated what is reasonable and necessary "in any particular case is always a matter of judgement in the circumstances". These are judgements which societies are expected to make and while societies should not be punished for good faith assessments "made on reasonable grounds...they cannot expect to be given spending entitlements by the Secretary in advance."

The Secretary considers that societies will exercise good judgement in these decisions if they keep their fundamental purpose in mind in addition to an appreciation of the scheme of the Act. Societies exist for one purpose; to raise funds for authorised purposes which they hold on trust for the community. The need for all costs incurred to be actual, reasonable and necessary fits with the scheme of the Act which reflects this singular purpose.

Minimising Costs and Maximising Net Proceeds

The prohibition in the Act on incurring costs that are not actual, reasonable and necessary is consistent with the duty to minimise operating costs and maximise net proceeds. The Commission has stated that these two express duties "are not in conflict" and are "of apparently equal weight".

It is not necessary to interpret the obligation by giving primacy to either. The Commission has said that it doubts the obligations prohibit the incurring of costs which would be expected to increase materially the net proceeds. The Commission went on to say "that conclusion does not mean that costs may be increased so long as there is some hope or expectation of additional gross revenue" (*emphasis added*). As

above, societies need to be able to justify all costs they incur including gambling equipment and management company costs.

As noted by the Commission, the overall sense conveyed by the scheme of the Act “is a requirement of conservatism in spending and the need to protect funds intended to benefit the community from speculation and waste”.

The Department also often hears arguments that because a society has above average returns to authorised purposes or the cost in question is a tiny fraction of GMP, then in respect of costs incurred a breach of the Act has not occurred. The equal weighting given to the requirements to minimise costs and maximise returns cannot excuse excessive expenditure. These duties are paramount and overlay any assessment of the necessity or reasonableness of costs incurred. Good returns to authorised purposes do not counter balance inappropriate spending.

Venue Developments and Enhancements and Limit C

Nature of Developments and Enhancements

This was a key area of The Southern Trust appeal. Gambling areas at venues had been upgraded with society branding and also with a consistent theme.

The Commission considered the expenditure was inspired by the competition that has existed throughout the sector. “The development and enhancement costs incurred contain a mixture of benefit to the venue operator (substantial capital improvements to the venue being paid for by the Trust) and incentive to stay (by incorporating branding and related elements in the work done)”. It was also argued that the expenditure would tend to increase gambling revenue. However, the “evidence was limited to a contention” there would be an increase “not that the increase would comfortably exceed the expenditure thus increasing net proceeds”.

The Commission has recognised that it is possible for a society to incur costs for developments and enhancements at a venue “if the state of the venue were such that the need for remedial work compromised the conduct of class 4 gambling” (*emphasis added*). The Commission went on to state that “just because such expenditure may sometimes be necessary and reasonable, it does not mean it generally is. In the Commission’s view, such expenditure by a society “is likely to be rare indeed”.

These statements by the Commission align with the above discussion on the necessity of incurring costs in the first instance and the Department’s stance that any costs incurred in this regard should be for the purpose of a “clean, comfortable and safe environment”. The Department will be assessing costs incurred on developments against the above test and will expect clear justifications if these costs are incurred in the future.

Incurring the Cost in the First Instance

In 2004 the Department amended the *Reference Paper* to allow societies to incur development and enhancement costs directly and noted its expectation that venue

operators would largely incur these costs in the first instance. It appears that a society incurring these costs upfront has since become the default position in many instances.

The Commission has stated that if a society elects to incur development and enhancement expenditure directly, “it is expected to be able to make a convincing case...for the society rather than the venue owner to incur the cost in each case”. The Commission went on to say that as “a general principle, using net proceeds which should be promptly distributed for authorised purposes to fund improvements to the property of others will not be easy to justify or reconcile with the statutory obligations of societies to the community”.

The Department’s expectation from 2004 is now reiterated. Where upgrades in the past have been based around creating a theme, removing the previous society’s theme or generally “enhancing” an otherwise suitable gambling space, it is understandable that venue operator’s would be reluctant to incur the cost in the first instance. However, if developments are kept to “remedial” matters and a strict necessity test, this should only result in an improvement of fixtures and will provide a benefit to the venue operator. A venue operator can then be reimbursed through the venue costs regime.

One of the themes in The Southern Trust appeal was that the cost of developments and enhancements was in danger of being lost when the venue changed societies. Where societies follow the above advice on incurring costs, the loss to the community will be minimised. If a society has good reason to incur a cost in the first instance, the Department expects societies to clearly document the obligations with the venue operator in terms of an outstanding debt for the remedial improvements that have occurred.

The standardised venue costs schedule will assist in tracking that “debt” and it may be that an incoming society will recognise the remaining cost as a “necessary” expense. If the enhancements are truly remedial, conservative and without theming or branding, there will be no need for an incoming society to incur further enhancement costs.

Venue Cost Schedules Section 69

The Commission has confirmed that any amendment to the venue costs schedule requires the Secretary’s approval under section 69 of the Act as it constitutes part of the venue agreement. The venue cost schedule represents the maximum amount that can be paid to a venue operator for its actual, reasonable and necessary costs. If a development and enhancement cost is incurred (or any other amendments are made to the venue costs schedule), it must be submitted to the Department for approval.

Sales and Marketing

At issue in The Trusts Charitable Foundation appeal was the costs incurred in a “venue expansion project”. An individual was contracted to seek new venues to sign with the society. The Commission, in assessing whether the costs were incurred in “conducting the gambling”, stated that a broad interpretation would extend to expenditure on competition for desirable venues “whereas a narrower interpretation

would limit such costs to the operational requirements of the existing gambling undertaken by the society” (*emphasis added*). The Commission considered the narrower interpretation to be the correct one.

The Commission accepted that a necessary cost of conducting gambling includes paying staff or an agent to oversee operations at venues and ensure legal obligations are being met such as signing new venue agreements. It also stated it “is possible such necessary expenditure may also produce incidental business development and protection benefits”. Again, this type of cost is constrained to meeting legal requirements and maintaining relationships while managing existing gambling operations.

The Commission has noted that the decision “does not mean that competition for venues is at an end” but that societies cannot “use gambling proceeds on pure business development or competitive spending”. The focus of the decision is on maintaining relationships in the context of current operations.

The effect of the decision is that competition for venues must become a passive exercise and remain within the bounds of a society’s core obligations. It is recognised that there are a finite number of class 4 venues. However, this form of competition is of no benefit to the community at large and is the genesis for many of the issues within the class 4 sector.

Entertainment and Leisure Costs

The Commission has not banned entertainment costs outright but stated it is not permitted with an aim of benefiting either the trustees or venue operators with whom a society “has or hopes to have venue agreements”. The Commission went on to state that “expenditure on pure business development, rewards and incentives for success in gaining or retaining venues and the entertainment of trustees or third parties is not necessary for the conduct of gambling or legal compliance”.

As with all costs the same test must be observed. Societies must ensure that any “entertainment costs” are necessary for the conduct of gambling and meet the obligation to minimise costs and maximise returns. If societies make a good faith assessment in this regard with a clear understanding of their obligations under the law and the fundamental purpose for which they conduct class 4 gambling, then there is nothing for those societies to fear.

Most of the breaches that led to the Commission’s decisions were the result of competition that exists in the sector. The nature of the competitive behaviour that has manifested over the years is in stark contrast to the purposes of the Act. It is not sustainable.

Conclusion

The Commission has recorded its expectation that the Department will investigate similar breaches and impose appropriate penalties. The Department is committed to doing so while wishing to see all societies motivated by maximising returns and minimising costs with a clear understanding of their responsibilities at law and to the community.

Yours sincerely

A handwritten signature in black ink, appearing to read "John Currie". The signature is written in a cursive style with a large initial 'J'.

John Currie
Acting National Manager Compliance
Gambling Compliance Group