

California State Auditor

B U R E A U O F S T A T E A U D I T S

Office of the Attorney General:

**Its Office of Gaming Registration Should
Protect Tax Documents More Rigorously
and Improve Some Procedures**



March 1998
97110

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CALIFORNIA STATE AUDITOR

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March 24, 1998

97110

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the Attorney General's Office of Gaming Registration (office) and its controls over sensitive personal and financial information submitted by owners, investors, and managers of gaming clubs. This report concludes that although its policy is consistent with state law, the office does not protect applicants' tax returns as rigorously as tax agencies. In addition, the office should improve some of its procedures for monitoring the status of sensitive documents.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Table of Contents

<i>Summary</i>	<i>S-1</i>
<i>Introduction</i>	<i>1</i>
<i>The Office of Gaming Registration Does Not Protect Taxpayer Information to the Same Degree as Tax Agencies</i>	<i>5</i>
<i>Recommendations</i>	<i>16</i>
<i>Appendix</i>	
Documentation Requirements for Gaming Club Registration	19
<i>Response to the Audit</i>	
Office of the Attorney General	21
California State Auditor's Comments on the Response From the Office of the Attorney General	25

Summary



Audit Highlights . . .

The Office of Gaming Registration:

- Has adequate physical security over sensitive documents.**
- Follows state law governing the release of confidential tax returns, which is less rigorous than corresponding federal and state tax agency laws.**
- Does not maintain a standard checklist to monitor the status of all confidential data.**
- Has kept inactive applicant files longer than necessary.**
- Lacks formal written policies and procedures to safeguard sensitive documents.**



Results in Brief

The Department of Justice (department), under the direction of the Office of the Attorney General, is responsible for regulating the activities of gaming clubs in the State. Enactment of the Gaming Registration Act (GRA) in 1983 created the Office of Gaming Registration (office) as the unit within the department responsible for overseeing the gaming clubs. The office's responsibilities include registering owners, investors, and managers of these clubs. As part of the annual registration, the office requires applicants to submit copies of sensitive financial information, such as Internal Revenue Service (IRS) income tax returns. This report focuses on the office's solicitation, use, and storage of applicants' tax returns.

The office's physical security over sensitive documents appear adequate. However, the office does not protect applicants' tax returns to the same degree as tax agencies. Although consistent with state law, its policy allows a law enforcement agency to access tax returns by providing notification that it is conducting a criminal investigation. This policy is considerably less rigorous than federal law, which specifically requires a court order or the taxpayer's consent to release the returns. Therefore, the office honors certain requests for access to tax returns that the IRS would normally not honor.

In addition, the office does not maintain a standard checklist to monitor the location and status of all sensitive documents for each applicant file. Because of the variety and sensitive nature of these documents, it is important that the office keep track of their status in order to protect the integrity of the file contents. Furthermore, the office does not have formal written policies and procedures that address the physical security of sensitive information, outside requests for sensitive information, and the method for reviewing applications. Finally, the office keeps documents longer than necessary. It has not scheduled hundreds of inactive applicant files for destruction.

Recommendations

In January 1998, the Gambling Control Act repealed the GRA and replaced the office with the Division of Gambling Control (division). The division will be assuming the responsibilities of the office. Therefore, to ensure that it will be objectively and uniformly overseeing the custody of sensitive personal and financial information, the division should do the following:

- Seek statutory authority to protect tax returns in accordance with federal standards. This statutory change would stipulate that the division inform the requester of an applicant file that the records include federal tax returns and that release of these returns requires a court order or the written consent of the applicant.
- Establish a checklist of all documents contained in the applicant file. The checklist should identify those documents required by the application instructions and additional documents that the division specifically requests from the applicant. The checklist should also indicate when these documents were received. For documents that were not received, the division should explain on the checklist whether their absence impacts the decision to license the applicant.
- Prepare formal written policies and procedures covering the physical security of applicant files, outside requests for sensitive information, and the review of applications and renewals for registration.
- Update its document retention schedule and transfer year-old closed files to the State Records Center for destruction.

Agency Comments

The attorney general disagrees with the recommendation to protect tax returns consistent with federal standards and states that it would result in an unnecessary limitation on the division's discretion. In addition, he states that the Office of the Attorney General will strongly oppose any effort to create such a limitation or to protect those individuals involved in gambling from law enforcement scrutiny.

The attorney general agrees with the other recommendations and states that his staff has already begun to implement the changes referenced in these recommendations.

Introduction

The Department of Justice (department), under the direction of the Office of the Attorney General, is responsible for ensuring that state laws are uniformly and adequately enforced. This responsibility includes preventing criminal activity. Recognizing the need to reduce the likelihood of criminal activity by owners and managers of gaming clubs in California, the State Legislature enacted the Gaming Registration Act (GRA) in 1983. The attorney general created the Office of Gaming Registration (office) within the department to administer and enforce this statute. The GRA covers Sections 19800 through 19826 of the Business and Professions Code and requires all owners, managers, and financial investors of California gaming clubs to register each year with the State.

Background

The objective of the office is to provide concurrent jurisdiction with local governments over gaming clubs in the State and to provide uniform regulation of their operation. A gaming club is an establishment, such as a card room, where legal gambling is conducted. By regulation, the office oversees the annual registrations of club owners, investors, and managers and also monitors these individuals throughout the year. The office originally reported to the department's Bureau of Investigations; however, in October 1995, the office began reporting directly to the chief deputy attorney general. The office consists of approximately 20 staff, of whom 8 are analysts and auditors responsible for the direct regulation of the gaming clubs. The rest of the staff provide management, legal, and technical support.

Under the GRA, an individual with a financial or managerial interest in a gaming club must register with the State. The individual must register separately for each gaming club interest by completing an application form detailing personal and financial information. In addition, the applicant must submit additional supporting documents, including fingerprint cards, lease or purchase agreements for the gaming club, loan documentation, bank statements, and income tax returns. The office assigns a staff analyst to coordinate the review of the application package and also seeks outside assistance during the review process. For example, the office sends the

fingerprint cards to the Federal Bureau of Investigation and the department's Bureau of Criminal Investigation and Information for background checks. In addition, the office will send parts of the application package to the department's Bureau of Investigation to check for possible organized crime connections. Based upon the application package and these inquiries, the analyst recommends whether the applicant should be registered. The manager of the office makes the final decision.

The GRA prescribes the grounds for denying an application. For example, the office may deny an application if the applicant has been convicted of a crime punishable as a felony, if he has made false statements on the application, or if he has a financial or other interest in a business or organization outside of California that is engaged in gambling or gaming not authorized under California laws. Applicants denied registration may appeal the decision with the Office of Administrative Hearings.

If the application is approved, the office issues a registration certificate to the applicant. The new registrant is required to adhere to GRA provisions. The office requires the applicant to provide proof of local license approval prior to the State issuing a registration certificate. At its discretion, the office may issue a conditional registration certificate, which allows an applicant to operate the gaming club pending completion of the background investigation.

The GRA requires registrants to renew their registration annually. The renewal process is similar to that of the initial application, although the individual does not have to submit as many supporting documents. As part of the year-round monitoring, the analyst monitors any changes in the club's ownership or management and responds to complaints against the club. However, the office does not conduct site visits at the gaming establishment. According to its manager, based on an appellate court decision, the office limited its review to a minimum background investigation. Instead, local cities and counties conduct site visits to regulate gaming clubs in their jurisdiction.

The Gambling Control Act Repealed the GRA

Chapter 867, Statutes of 1997, enacted the Gambling Control Act, a new set of regulations intended to provide greater supervision over gaming clubs and to prevent criminal involvement in these establishments. This act repealed the GRA and restructured the role of the department in its monitoring of

gaming clubs throughout the State. Effective January 1, 1998, the Division of Gambling Control (division) replaced the office. All owners and key employees of a gaming club must each obtain a license from the division in order for the club to operate in the State. The new act continues to give the division the authority to require applications and personal and financial information from applicants, but increases the number of years' worth of information that the division can request. Specifically, the division can now request up to ten years of financial information, as opposed to the office's previous policy of only three years' worth of financial records. The new act also establishes a schedule for calculating license fees based on the number of gaming tables in the club.

The Gambling Control Act allows the department a transition period, from January 1 to June 30, 1998, to phase in its specific provisions. The division is currently developing operational procedures modeled after those of the Nevada Gaming Control Board, the agency that the new act is based on. In addition, the division will continue to report directly to the chief deputy attorney general. Initially, the act creates an interim three-member Gambling Control Board responsible for appellate review of the division's licensing decisions. By January 1999, the governor will replace the board by appointing a five-member, full-time Gambling Control Commission. In addition to reviewing appeals, the commission will also have regulatory authority over gaming clubs within the State.

Scope and Methodology

This audit of the office addresses its solicitation, use, and storage of sensitive personal and financial documents, such as Internal Revenue Service statements of gaming club owners, investors, and managers, since the GRA's enactment in 1983. We focused our review on the office and the GRA, since the department had not fully implemented the provisions of the Gambling Control Act and the successor division at the time of our review.

To understand the nature and requirements of the office, we reviewed the federal and state laws, rules, and regulations relevant to the solicitation, use, and storage of each applicant's financial data, including Internal Revenue Service income tax returns of card club owners, investors, and managers. We reviewed the office's written instructions to applicants to assess whether these instructions adequately describe the confidentiality of the requested information and are consistent with federal and state laws, rules, and regulations. We also

interviewed office staff to identify the procedures and supporting documentation that the office uses to review applications.

To determine whether security of the confidential information was sufficient, we checked for office policies, procedures, and guidelines for requesting, reviewing, and retaining applicant information. We documented and observed the office's physical controls over access to and maintenance of sensitive information. We also reviewed a sample of applicant files and checked for the appropriateness of and control over documents in the files. In addition, we reviewed inactive files stored at the State Records Center. To identify whether the office conformed to its policies and state and federal laws when addressing requests for information, we selected a sample of requests and determined their source and purpose and the appropriateness of the office's response.

The Office of Gaming Registration Does Not Protect Taxpayer Information to the Same Degree as Tax Agencies

Summary

The Office of Gaming Registration (office) does not protect certain sensitive tax information submitted by gaming club owners, investors, and managers in the State as rigorously as when this information is in the hands of tax agencies. Although the office's physical protection over sensitive documents appears adequate, it allows easier access to the applicants' income tax returns by law enforcement agencies than is allowed by the Internal Revenue Service (IRS). Specifically, although consistent with state law, the office's policy regarding access to applicants' income tax returns is less rigorous than the IRS requirements, meaning that the office honors certain requests for tax returns that the IRS does not honor. The office's policy is also less strict than that of the Franchise Tax Board (FTB), a state agency that possesses federal tax returns. This issue has greater significance in light of the Gambling Control Act whereby the Division of Gambling Control (division) can now require up to ten years' worth of tax returns and will maintain far more personal tax information than under previous laws.

In addition, the office does not have a centralized written record of the contents of each applicant file because it does not maintain a standard checklist that allows it to monitor the location and status of all sensitive documents requested and received. Because of the variety and sensitive nature of these documents, it is important that the office keep track of their status to protect the integrity of the file contents. Furthermore, the office retains sensitive documents longer than necessary. Specifically, the office has not scheduled hundreds of inactive applicant files for destruction.

Finally, the office does not have formal written policies and procedures that address its operations. Specifically, the office lacks written procedures discussing the physical security of sensitive information, outside requests for sensitive information, and the method for reviewing applications.

The Office Maintains Sensitive Documents in Applicant Files

When an individual applies for an initial registration certificate, the office sets up an applicant file to store the documents used in the review process. The office assigns a document control number to track the file's status. File contents include the application, supplemental documents, and correspondence pertaining to the application. Most files contain copies of the applicant's past income tax returns. The file also contains a decision form that summarizes the basis for approval or denial of an application. In addition, the file contains renewal documentation. Individuals with interests in more than one gaming club must register for each club separately, and in these instances, the office includes registration documentation for these clubs in the same file.


The Office Does Not Protect Certain Sensitive Information as Rigorously as the IRS Does

—◆—
Although consistent with state law, office policy to protect confidential applicant information is less strict than corresponding federal and state tax agency laws.
—◆—


Although consistent with state law, the office's policy does not require it to safeguard applicants' sensitive tax returns with the same rigor as the IRS. The office requires three years' worth of tax returns in order to verify the financial information provided on the application form. Therefore, the applicant is compelled to provide these returns as a condition of registration. In addition, the Gaming Registration Act (GRA) allows the office to request additional financial information, including other tax returns deemed necessary during the review process. Although the office's procedures for responding to requests for applicant information under the Public Records Act (PRA) seem sufficient, we have concerns about requests for sensitive information made outside the PRA, such as by law enforcement agencies. Specifically, those state laws governing the release of sensitive information to outside entities are less strict than the corresponding federal and state tax agency laws.

The office deals with two types of requests for applicant information: those requested under the PRA and those requested outside of the PRA. In enacting the PRA, the Legislature recognized that access to information concerning the conduct of government business is a fundamental and necessary right of every person in the State. Accordingly, the PRA allows access to public records of state or local agencies during normal business hours.

Under the PRA, the office must disclose certain portions of an application, such as the applicant's name and the address of the gaming club. However, information concerning the applicant's personal worth and criminal history are exempt from disclosure. Therefore, in response to a PRA request, the office informed us that it blocks out confidential information on the application form before it releases a copy to the requester.


When releasing applicant information under the Public Records Act, the office did not always block out all confidential data consistently.

We reviewed eight PRA requests and copies of the application forms that the office sent in response to these requests. All eight forms had certain sections of the applications, such as the residential address and financial information, completely blocked out. However, for seven of the eight forms, the office did not fully block out the applicants' responses to all of the questions regarding criminal activity, although it did remove specific references to the applicants' criminal history.



Further, we identified another file containing an application form in which the office did not block out the criminal history information. The office's legal counsel believed that the office did not release this application pursuant to a PRA request, but instead sent this copy to a law enforcement agency in another state, who had specifically inquired about the information on the application. However, the correspondence in the file pertaining to this release of information was a letter that referred to this occurrence as a PRA request.

According to the office's legal counsel, the office has amended its application form four times during the past six years. Each time it made a change, the office sent the new form to attorneys at the Office of the Attorney General, who had experience and expertise in dealing with the PRA. These attorneys reviewed the new form to determine which items of information were required to be removed prior to complying with a PRA request. However, the office does not have any written policies describing the attorneys' decisions for excluding release of certain information.


Under the Gambling Control Act, the division plans to separate its application process to include different forms. The main form will contain public information that can be released under the PRA. The supplemental forms will contain confidential information exempt from disclosure. The division will respond to PRA requests by only sending the main form. It will no longer need to block out specific information on the application.

Under certain circumstances, state law allows an agency to release confidential information that is normally exempt from the PRA. According to the manager of the office, prior legal

counsel developed a policy based on Section 1798.24 of the California Civil Code allowing certain outside entities to access personal information in the applicant files. Specifically, the office will allow a government agency to review an applicant's file if the agency provides a letter stating that it is conducting a criminal investigation of the applicant and needs access to the file. Section 1798.24(e) and (o) of the Civil Code allows disclosure of personal information to law enforcement or regulatory agencies for an investigation of unlawful activity. However, this law does not specify any restrictions regarding the method or contents of the request for access.



Unlike state law, federal law requires a court order to access tax returns for criminal investigations.




In contrast, federal law stipulates stricter requirements for the release of applicants' income tax returns. Section 6103(i)(1) of the United States Code, Title 26 (Internal Revenue Code), requires a federal district court order for federal officials or employees to access tax returns for criminal investigations not specifically relating to tax administration. This procedure differs significantly from the office's requirement of a letter stating that the agency is conducting a criminal investigation and needs access to the file. In fact, when the office grants this type of request, it allows the agency to review the entire file, including tax returns for all years, as well as other confidential documents.


Under the GRA and Section 1798.24(k) of the Civil Code, the office must also allow access to personal information when it receives a subpoena for an applicant's records. Attorneys use subpoenas to obtain evidence for civil, criminal, or administrative proceedings. For example, a plaintiff's attorney in a civil lawsuit pertaining to a failed business can access the financial records of the business's supplier by issuing a subpoena directly to the supplier. The court does not need to review or approve the subpoena. Therefore, the attorney has considerable discretion regarding the subject and extent of the subpoena.

State law requires the issuer to directly notify the applicant of the subpoena. According to its manager, as a courtesy, the office also contacts the applicant regarding the subpoena. The applicant may file a motion to quash, which means that the court will temporarily suspend the subpoena, preventing the office from releasing any information until the court reviews the applicant's argument against releasing the information. Formerly, under the GRA, the office was required to release personal information pursuant to Section 1798.24(k) of the Civil Code, unless notified by a court of the applicant's motion to quash; however, the new Gambling Control Act stipulates that, notwithstanding this section, a court shall not compel the division to disclose applicant information unless the

requester can demonstrate good cause and show that the information cannot otherwise be obtained. The manager informed us that absent a court order to compel, the division will only release information pursuant to the PRA. It will not release tax returns or other financial documents, even if the subpoena directly requests them.


Some requests for file information are oral while others are in formal written form; the office does not maintain a written record of denied requests.

According to its manager, there have only been a few occasions when the office has allowed a law enforcement agency to access an applicant file. While he also stated that there have been oral requests for files by law enforcement agencies, few agencies submitted formal requests after the office informed them that their requests must be in writing and pertain to an official criminal investigation. The office does not maintain a written record of denied requests.



The manager provided us with a request letter, dated April 1996, from the Federal Bureau of Investigation (FBI), which was conducting a criminal investigation of two gaming clubs and requested access to the applicant files pertaining to the clubs. The manager informed us that he allowed the FBI agents to come to the office to review the files on-site. The manager also provided us with a request by the IRS in February 1997 for access to applicant information. This example was a summons from the IRS requesting financial information in an applicant's file. The office notified the applicant of the summons and advised him to contact the IRS or seek legal counsel if he had questions. According to the manager, the applicant did not inform the office that he opposed the release of this information. Therefore, the office interpreted this nonresponse as the applicant's permission to release the information. The office mailed copies of the requested documents directly to the IRS.

Further, during our review of the applicant files and various other department correspondence, we found four other requests for access to records outside of the PRA for which the office granted access to the files. Two of these requests came from law enforcement agencies conducting criminal investigations. In one case, dated July 1991, the office provided the agency with copies of correspondence and licenses from the applicant's file, but did not release any tax returns. In the other case, dated June 1997, the office allowed agency representatives to review files on-site. Another request came from a government agency serving a subpoena in July 1990. At the time of the request, the Audits and Record Security Section (ARSS) of the Department of Justice handled the release of records. After communicating with the office, the ARSS released copies from the applicant's file. The office informed us that the list of specific documents released is not available because the ARSS no longer exists.


The other request came from the Nevada Gaming Control Board (board). The board wanted to review the file of a prior applicant in California who was currently applying for a gambling license in Nevada. Because this request, dated September 1997, included a letter from the applicant granting the office permission to release information from his file, the office permitted an investigator from the board to review the file. According to the manager, the investigator developed information during his review concerning a possible illegal relationship between the applicant and another person who had also applied for registration with the office. The investigator asked to review the file of the other applicant and the office's legal counsel granted the request. The manager informed us that the investigator did not review tax information or make copies of records in this second file.

We consulted with our legal counsel for an interpretation under state law regarding the proper release of sensitive personal and financial information to outside entities. In responding to a request by a law enforcement agency, the office is allowed to release the information in accordance with Section 1798.24(e) and (o) of the Civil Code. Under the GRA, the office could comply with a subpoena unless the applicant submitted a motion to quash to the court. Under the new Gambling Control Act, the division must require a court order before it can comply with a subpoena requesting personal and financial information.

However, the office is in a unique position because it is a custodian of federal income tax returns. By receiving access to an applicant file, the law enforcement agency also gains access to the applicant's tax returns, regardless of whether its initial intent included reviewing these returns. The FTB, a state agency that also possesses federal tax returns, has a reciprocal agreement with the IRS requiring that these returns have the same confidential protection as those maintained by the IRS. Furthermore, in its guidelines to federal, state, and local agencies for securing tax information, the IRS recommends that agencies, such as the FTB, avoid commingling tax records with other types of documents in order to keep the tax records confidential. Similarly, we see no reason why the office should not protect applicants' tax returns to the same degree as the IRS or the FTB.




*The Franchise Tax Board
protects tax returns to the
same degree as the
Internal Revenue Service.*



The office informed us that it retains tax returns to develop a financial profile of the applicant. After it completes the initial investigation, the office uses the tax returns for subsequent investigations concerning the applicant's renewal applications. The office stated that, because applicants know it

retains these returns to compare with future financial information, they are deterred from submitting false information on subsequent applications.

The office also informed us that it has found old tax returns to be very useful in determining the source of funds used to finance gambling establishments. For example, one applicant, who claimed to have obtained the funds used to purchase a card room from the sale of certain real estate, attempted to use a subsequent alleged sale of the same property, a few years later, as the source of the funds for the development of a different card club. In another case, an applicant attempted to conceal the source of funds used to build a new card club by claiming that it came from a loan. However, old tax returns revealed that the funds actually came from an individual not eligible for registration, who was attempting to conceal his interest in the card club.



In future years, the office will retain more tax returns, making it important that it rigorously safeguard these documents.

Under the new Gambling Control Act, the division may request up to ten years' worth of tax returns. Therefore, in future years, it may retain significantly more tax returns, making it more important that it safeguard these tax returns more rigorously. Since the division believes that retaining tax returns assists in its licensing responsibilities, it should seek enactment of a state law consistent with federal requirements to restrict outside access to these documents.



Physical Protection of Sensitive Information Appears Adequate

The office's controls over the access and maintenance of applicants' sensitive personal and financial information appear adequate. These controls, such as general physical security, file maintenance, and instructions to employees, ensure that it protects sensitive information from unauthorized access.


We observed that the office's physical location is secure. The office, located in a building separate from the Department of Justice headquarters, is locked and access is limited to employees with card keys. Visitors check in with the office receptionist and sign a log book.

The office's policy is to keep applicant files in a locked file room. Staff will sign out for files needed for review. When employees take a file from the room, the office instructs them to replace the file with a card signifying that the file has been removed. Although the office's policy requires that staff return


all files to the file room at the end of the day, analysts and auditors who need files for extended periods will instead secure these files in their desks.

The office sends closed and inactive files to the State Records Center (center). A file is considered closed when the applicant is no longer registered with the State. This could occur if the applicant fails to renew his registration by the deadline. Alternatively, the office will close the file of an applicant that no longer has a financial interest in or no longer manages a gaming club. The office instructs the center to destroy these files ten years after they are received. If an inactive owner resumes involvement with a gaming club, then the office reopens the file and requests its return from the center.

Another security precaution is that the office completes extensive background checks on all prospective employees before allowing them to handle confidential information. The office instructs staff about the confidentiality of the applicant files. Staff may not discuss the content of applicant files with anyone other than the applicant or the applicant's attorney. These procedures ensure that those who handle sensitive information are aware of the nature of the records and maintain their confidentiality.



Although physical protection over sensitive files appears adequate, the office lacks written policies and procedures over security and maintenance of files.



Although the office's physical protection over sensitive documents appears adequate, the office does not have formal written policies and procedures describing the physical and procedural controls over office security and maintenance of applicant files. While it has a written document that outlines the safeguarding of files and other daily operations, the office has not expanded these procedures and incorporated them into a formal policy manual. Also, the office does not have formal written procedures for addressing requests for sensitive information, despite the increased volume and varied contents of applicant files, particularly during the past few years. The manager informed us that the division will be updating its policies and procedures to be consistent with the Gambling Control Act.

In addition, the office does not have written policies describing procedures for analysts conducting application and renewal reviews. Under the GRA, the office started out with just a few staff and a much simpler registration process. According to its manager, the office provided on-the-job training for its analysts, along with management review of the analysts' work. This approach seems reasonable in a smaller office environment. However, the enactment of the Gambling Control Act increases the size and responsibility of the division. Specifically, the division plans to hire several new analysts to

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With an increasing staff and a greater number of sensitive documents, the office has more need for written policies outlining analysts' responsibilities.


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assist in the license application reviews. Also, the division will require applicants to submit a greater number of sensitive documents than required under the GRA. Accordingly, there is now a greater need for written policies discussing the analysts' responsibilities. We would expect the division to have a detailed list of procedures to ensure new staff are reviewing applications and renewals in accordance with the Gambling Control Act. Standard procedures would ensure that the new analyst could perform a review consistent with the division's expectations and that the division can better support its decisions in the event an applicant appeals.

***The Office Does Not Keep Standard
Written Records Accounting for
the Contents of Applicant Files***

The office does not maintain a standard checklist for its applicant files that allows it to monitor the status of all sensitive documents requested, received, and retained. The information stored in a file can vary from one applicant to another, depending on when the individual first registered and whether the analyst specifically requested additional documents beyond those required by the application instructions. Therefore, to protect the integrity of the file contents, it is important that the office have a written record that tracks the status of all documents.

During the office's existence, it has revised its policy on the types of supporting documents, such as tax returns, that it requires to accompany the application. As seen in the Appendix, a file's contents will vary depending on when the applicant first registered with the State. For example, a gaming club owner that initially applied in 1995 was required to submit tax returns for the 1992, 1993, and 1994 tax years. In contrast, an owner that first registered with the State in 1993 did not have to submit any tax returns, although he would submit them during his subsequent renewals. In addition, the analyst reviewing the application has the authority to request additional documents beyond those required initially by the application package. For example, an analyst may request the applicant to submit tax returns for a business owned in another state. Also, in certain instances when the analyst did not receive all the documents requested, the office may approve the issuance of a conditional registration certificate upon receipt of minimum requirements, such as criminal and personal history information. As a result, the contents of files may vary significantly, even for those individuals that first registered in the same year.


The information stored in an applicant file can vary depending on the applicant; therefore, it is important for the office to have a written checklist that tracks the contents of each applicant file.

We found that the office does not use a written checklist to track the contents of its applicant files. A checklist of the file contents is particularly important because the file contains a considerable amount of sensitive personal and financial information. We reviewed a sample of 61 applicant files and observed that, in some, it was unclear as to the status and location of one or more sensitive documents. We noted 14 files that did not contain tax returns for certain years even though the office specifically requested them. For example, we reviewed one file that included tax returns for 1992 and 1994 but did not contain one for 1993. We were unclear as to whether the office actually received and misplaced this tax return or never actually received it because there was no annotation in the file explaining why the return was not there. Another file did not contain the applicant's 1995 tax return and instead had two copies of the 1994 return. Although the office may have reasonable explanations for the absence of the returns, our concern is that without a written explanation, the office would have to reconstruct a document's status by reviewing the various items of correspondence in the file.


We also found one file that did not contain application forms or tax returns for three years. We asked the office to explain why the file did not include these forms. Although the office's explanation seemed reasonable, the file did not have a central written record providing this explanation. Maintaining a written record of supporting documents would assist the office in tracking their status.

In addition, we observed another file containing a police report received in May 1992 with a notation that the office should destroy the report "after review committee meeting." Although the office security procedures require staff to shred all unnecessary confidential information in applicant files, more than five years later, the office still had not destroyed this confidential document. The office has since informed us that it has destroyed this document. With no written method of tracking documents in the files, the office relies on its analysts to maintain the files and remove and destroy extraneous documents. With employee turnover or reassignments, the office increases the risk that nonessential confidential documents remain in the files.

According to its manager, in the office's early years, it did not develop a method of tracking the status of documents because of limited resources and staff. The manager informed us that the office could determine those items requested and received by examining the correspondence. However, as previously mentioned, the size and responsibility of the new division will increase along with the number of years' worth of tax returns

that may be requested. Therefore, the files will contain more sensitive documents than before. As a requester and custodian of these documents, the office has the responsibility of tracking their status and disposition.

The Office Retains Sensitive Financial Information Longer Than It Should


Rather than sending them to the State Records Center as they should, the office has held boxes of closed applicant files on-site.

As mentioned previously, the office's current policy is to send files closed for one year to the center for storage. The center retains the documents for 10 years before destroying them. However, we noticed that the office was holding on to several year-old closed files on-site rather than sending them to the center. We also saw 35 boxes of closed files in the office's file room that were waiting to be shipped to the center. During the 13-year period since the GRA's enactment, the office sent only two shipments of files for storage, one in May 1990 and another in September 1994. By holding on to closed files, the countdown period for destroying these files does not begin. As a result, many sensitive documents for individuals no longer affiliated with gaming clubs may not be destroyed as they should. According to the manager of the office, the center is not accepting shipments until the office updates its schedule for document retention, which is being completed at this time.

Conclusion

The office's policy for releasing tax returns in its applicant files is less rigorous than IRS requirements. As a result, the office allows law enforcement agencies to access tax returns in its possession with greater ease than if the agencies sought the same returns from the IRS. In addition, the office does not maintain checklists describing the location and status of all sensitive documents requested and received. Therefore, there is no central written record to support the integrity and completeness of the file. Moreover, the office lacks formal written policies and procedures that address its operations, including the physical security of sensitive information, outside requests for sensitive information, and the method for reviewing applications. The office also retains sensitive documents longer than necessary.

Recommendations

To ensure that it will be objectively and uniformly overseeing the custody of sensitive personal and financial information, the Division of Gambling Control (division) should do the following:

- Seek statutory authority to protect tax returns in accordance with federal standards. This statutory change would stipulate that the division inform the requester of an applicant file that the records include federal tax returns and that release of these returns requires a court order or the written consent of the applicant.
- Establish a checklist of all documents contained in the applicant file. The checklist should identify those documents required by the application instructions and additional documents that the division specifically requests from the applicant. The checklist should also indicate when these documents were received. For documents that were not received, the division should explain on the checklist whether their absence impacts the decision to license the applicant.
- Prepare formal written policies and procedures covering the physical security of applicant files, outside requests for sensitive information, and the review of applications and renewals for registration.
- Update its document retention schedule and transfer year-old closed files that remain at the office to the State Records Center for destruction.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

A handwritten signature in black ink that reads "Kurt R. Sjoberg". The signature is written in a cursive style with a prominent initial "K".

KURT R. SJOBERG
State Auditor

Date: March 24, 1998

Staff: Steve Hendrickson, Audit Principal
Linus Li, CPA
Kathryn Lozano

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Appendix

Documentation Requirements for Gaming Club Registration

Governing Regulation	Gaming Registration Act, Business and Professions Code, Sections 19800 Through 19826	Gambling Control Act, Business and Professions Code, Sections 19800 et seq.
Initial Application		
<i>Applicable Years</i>	1984-1994	1995-1997
<i>Documentation Required</i>	<ul style="list-style-type: none"> • Application form • Application fee • Fingerprint cards • Beginning in 1990, the Office of Gaming Registration began requesting tax returns from some applicants 	<ul style="list-style-type: none"> • Application form • Application fee • Fingerprint cards • Current gaming club permit issued by a local jurisdiction • Last three years of federal income tax returns • Bank statements for the 18 months prior to the application date • If an owner or majority investor: <ul style="list-style-type: none"> - lease agreement - purchase agreement - loan documentation - partnership agreements or articles of incorporation
		1998-
		<p>As of January 1998, the Division of Gambling Control (division) has not yet specified the new documentation requirements under the new Gambling Control Act.</p> <p>However, pursuant to the Business and Professions Code, Section 19853.5, the division has the authority to require information from applicants covering the</p>
Renewal Application		
<i>Applicable Years</i>	1985-1993	1994-1997
<i>Documentation Required</i>	<ul style="list-style-type: none"> • Application form • Renewal fee 	<ul style="list-style-type: none"> • Application form • Renewal fee • Current gaming club permit issued by a local jurisdiction • Past year's federal income tax return • If an owner or majority investor: <ul style="list-style-type: none"> - an annual financial statement for the gaming club
		1998-
		Same as for initial application (see above)

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Agency's response to the report provided as text only:

STATE OF CALIFORNIA
OFFICE OF THE ATTORNEY GENERAL
Daniel E. Lundgren, Attorney General
Wayne R. Smith, Special Assistant
1300 I Street, Suite 1730
Sacramento, CA 95814
(916) 323-9569

March 17, 1998

Mr. Kurt R. Sjoberg
State Auditor
California State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

Under the authority of Section 8543 of the Government Code, the California State Auditor (Auditor) has completed an audit of the Office of Gaming Registration. After that audit, the Auditor made one recommendation for a statutory change and three recommendations relating to procedural changes in the operation of the Division of Gambling Control (Division) as follows:

1. The Division should seek statutory authority to protect tax returns to the same extent they are protected by the Federal Internal Revenue Service (IRS);
2. The Division should establish a checklist of all documents contained in an applicant's file;
3. The Division should update its document retention schedule; and
4. The Division should prepare formal written policies and procedures relating to the handling of applicants' files.

①*

Before I address any of the recommendations in detail, I feel some historical perspective would be helpful in understanding the foundation of the policies of the Office of the Attorney General (Office) as they relate to this matter. The best place to start is the legislation upon which the former Office of Gaming Registration was based.

Recognizing the need to reduce or eliminate the likelihood of any criminal involvement in the ownership or management of gambling establishments in California, the State Legislature enacted the Gaming Registration Act in 1983. More recently, the Legislature enacted the Gambling Control Act (Act) in 1997. Section 19801 of the Act deals with legislative findings and

*California State Auditor's comments on this response begin on page 25.

declarations. This section provides in pertinent part that, “[T]he longstanding public policy of this state disfavors the business of gambling . . . Unregulated gambling enterprises are inimical to the public health, safety, and welfare and good order. Accordingly, no person in this state has a right to operate a gambling enterprise except as may be expressly permitted by the laws of this state and by the ordinances of local governmental bodies.” The Act also makes the Department of Justice primarily responsible for ensuring that unsuitable persons are not involved with gambling in California.

The Attorney General would be the first to admit that the majority of individuals involved in the gambling industry in California are honest and hard working. However, I feel I can safely say that this is largely a result of stringent regulation of this industry. In addition, based on past problems within the industry and actions this Office has had to initiate, the Attorney General takes very seriously his ongoing statutory responsibilities as they relate to this industry and the citizens of California. This Office firmly believes that this has helped maintain the integrity of the industry and the safety of its patrons and neighbors.

I would like to address the recommendations set forth in the report in the order they are presented. The State Auditor recommends that the Attorney General seek statutory authority that would restrict the use of tax return information to be consistent with guidelines used by the IRS. This recommendation indicates a misunderstanding of the fundamental differences between tax agencies and law enforcement agencies. The purpose of a tax agency is to raise revenue for the government. Therefore, although residents are compelled, under penalty of prosecution, to reveal all relevant financial information to determine the amount of tax owed, that evidence cannot be used against them in other matters. Accordingly, to protect the individual tax payer’s constitutional right against self-incrimination, the tax agency is restricted in the release of such financial information to other governmental agencies which could use it against the tax payer.

On the other hand, the purpose of law enforcement agencies is to protect and serve the public by enforcing the law. As provided in the Act, no one has the right to be involved in a gambling business. It is a privilege created by the Act. The role of the Division is to ensure that licensed gambling operations are not conducted in a manner that is inimical to the public, health, safety or welfare and that unsuitable persons are not associated with such operations. Therefore, any individual who wants to take advantage of the privilege to be involved in a gambling operation must make a conscious choice to submit all of the necessary financial information to the Division, with the understanding that, if applicable, such information can and will be used against them. Therefore, to the extent that such information could lead to a determination that an applicant is unsuitable to be associated with a gambling operation, it should be available to other law enforcement agencies to facilitate their investigations. Accordingly, the Division needs to have broad discretion to share information with other law enforcement agencies that are conducting related investigations. While it is not readily apparent from reading the audit report,

this discretion is currently authorized by and consistent with existing state law. Consequently, applicants understand that should they apply for a gambling license, their files will be available to law enforcement agencies involved in legitimate criminal investigations. The Attorney General feels that this serves as a powerful deterrent to persons, of less than desirable character, who might otherwise attempt to enter the gambling business in California.

For those reasons, as the chief law enforcement officer for the State of California, the Attorney General rejects this recommendation because it would result in an unnecessary limitation on the discretion of the Division. Furthermore, this Office will strongly oppose any effort by anyone to create such a limitation or to otherwise protect those involved in gambling from law enforcement scrutinies.

I concur with recommendations 2 through 4 that relate to the procedural changes. Prior to the start of the audit, my staff had already begun to implement the changes referenced in those recommendations. In fact, the recommended checklist has already been created and provided to the auditors. The checklist will be used for processing all existing and new applications. The Division is also in the process of drafting and finalizing a retention schedule and updating its written policies and procedures to bring them in line with the Act. These written policies and procedures will cover every aspect of every Division process, not just those dealing with outside requests for sensitive information and the review of applications. Those policies and procedures will be implemented when the Division becomes fully operational on July 1, 1998.

Although there are a number of inaccuracies in the report concerning Division records and representations made by Division staff to the audit committee, they are not material to the recommendations and will not be addressed in this response. (4)

In conclusion, Division staff have already addressed the last three recommendations in the report. For the reasons stated above, the first recommendation will not be accepted because the Attorney General cannot and will not forsake his responsibilities to the citizens of California for the sake of political expediency or appearances.

Very truly yours,

Wayne R. Smith

WAYNE R. SMITH
Special Assistant

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Comments

California State Auditor's Comments on the Response From the Office of the Attorney General

To provide clarity and perspective, we are commenting on the Office of the Attorney General's (attorney general) response to our audit report. The numbers correspond to the numbers we have placed in the response.

- ① The draft copy of the report presented our recommendations in the order referred to in the attorney general's response. We later switched the order of recommendations 3 and 4 in our final report.
- ② We understand the difference between the purpose of a tax agency and a law enforcement agency as well as the respective differences pertaining to their possession and use of tax returns. However, we believe that because the Office of Gaming Registration (office) chose to require tax returns as part of the application process, it must assume a higher responsibility to protect these returns in accordance with Internal Revenue Service (IRS) standards regardless of who requests them. Accordingly, we stand by our recommendation.
- ③ We agree that the attorney general can share information contained in the applicant files with other law enforcement agencies. As we point out on pages 7 through 10 of the report, current state law allows the office to disclose this information. However, this state law does not specifically address the confidentiality of tax returns. Because the office chose to require tax returns as part of the application process, it includes these returns in the applicant file and discloses them to requesters as part of the entire file. On the other hand, Section 6103(i)(1) of the Internal Revenue Code is specific in discussing the confidentiality of tax returns and applies a rigorous standard for allowing access to these returns. This section does not preclude a law enforcement agency from accessing a tax return if it can demonstrate its need for the return to a federal court. Furthermore, if the office does not possess tax returns, as was the case prior to 1990, a law enforcement agency that specifically wanted to access an applicant's returns would have to request them directly from the IRS and adhere to the rigorous standard anyway.

- ④ We spoke with the office's legal counsel to clarify the attorney general's reference to inaccuracies in the report. While we do not believe they were inaccuracies, we responded to these concerns by modifying the wording in those sections that needed clarification.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps