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Investigation into the Improper Takeout Rate Charged by the New York Racing Association, Inc.

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I. EXECUTIVE SUMMARY

In April 2012, the New York State Inspector General commenced an investigation into a 15-month overcharge by the New York Racing Association, Inc. (NYRA) of a certain wager takeout rate, a percentage of the total amount of money wagered on a race that is retained by NYRA. Specifically, NYRA had charged one percent more than was legally allowed for its exotic wagers – wagers that involve more than one race or more than one racehorse and, therefore, have larger payoffs. The Inspector General found that every level of internal control and audit at NYRA failed to identify the incorrectly charged takeout rate. These failures occurred, in part, because of NYRA's inadequate policies and procedures and deficient audit plans.

In New York State, takeout rates for horse racing are dictated by statute. In June 2008, legislation was enacted that, among other actions, changed the takeout rates NYRA could charge. The legislation created an effective one percent increase in the takeout rate of all wagers placed on races run on NYRA tracks, and, importantly, included a sunset provision that the increase would expire after two years, on September 15, 2010. The Legislature accordingly raised the floor on the range of most of NYRA's takeout rates to impose the one percent increase. With regard to the exotic takeout rate, however, NYRA was already employing a takeout rate at the top of the previously permitted range of 15-25 percent. Therefore, in contrast to the other types of wagers, the Legislature imposed a fixed rate of 26 percent for exotic bets. The Inspector General determined that NYRA failed to identify this fixed rate and to calendar the sunset date to ensure compliance with the statute.

First and foremost, NYRA's law department failed to ensure that NYRA was complying with the statutorily mandated takeout rates for its wagers. Former General Counsel Patrick

Kehoe did not make a written notation of this sunset date in his work calendar, nor did anyone else in the law department. William Crowell, NYRA's former legislative counsel and lobbyist, similarly testified that he did not calendar the sunset date of the increase in takeout rates. More significantly, however, even if they had calendared the date, the investigation revealed that NYRA did not appreciate or take note of the implications of the sunset provision related to the fixed 26 percent takeout set for exotic wagers, at least at the time the sunset provision was triggered and, in some instances, never. Specifically, when the statute expired and the takeout rates reverted to the pre-June 2008 rates, NYRA was operating under the misimpression that the takeout rates *could* be lowered, and not that the exotic takeout rate *must* be lowered to ensure compliance with the law. Former NYRA President and Chief Executive Officer Charles Hayward testified to operating under this misunderstanding of the law as well.

Aside from an inexcusable inattention to the details of the newly enacted 2008 legislation by Kehoe, NYRA Assistant General Counsel Pasquale Viscusi also failed to monitor the new takeout legislation. In August 2008, Viscusi responded to an inquiry from the NYRA simulcasting department regarding this newly enacted legislation. Notably, Viscusi provided the department a detailed analysis of the legislation that indicated his understanding of the fixed takeout rate of 26 percent for exotic wagers, but when testifying before the Inspector General in 2012, Viscusi denied knowledge of the fixed rate. Regardless, Viscusi, who also held the title of NYRA Regulatory Compliance Officer, did not deem the sunset of the takeout legislation to be within his purview so as to calendar it or memorialize it in any way.

In addition to failing to calendar the sunset date and to accurately note the fixed takeout rate for exotic wagers, NYRA's law department missed other opportunities to prevent this substantial error, as demonstrated by, among other evidence, emails in late September 2010 and

October 2010 in which Kehoe discussed the sunset of the takeout law with Crowell and Hayward. These emails reveal that Kehoe had ample opportunity to uncover NYRA's exotic wager takeout overcharge but simply failed to do so. In addition, as NYRA's then legislative counsel, Crowell should have reviewed the statute relating to NYRA, his longtime client, and inquired if any legislative or remedial action was required. Instead, he simply sent Kehoe the requested legislation and did nothing else.

NYRA missed another opportunity to identify and rectify this problem in August 2011, when Steven Crist, Hayward's longtime friend and the publisher and columnist of the *Daily Racing Form*, contacted Hayward asking for a comment regarding a question posed by one of his readers. Crist forwarded Hayward the reader's email inquiry, which asked when NYRA would lower the takeout rates and correctly stated that the takeout rate for the exotic wagers was "currently outside the parameters of the law." The reader also noted that if NYRA wanted to lower takeout, all it had to do was request to do so from the New York State Racing and Wagering Board, the agency charged with regulating, among other gaming operations, horse racing in in New York State.[1] Hayward responded to Crist that this reader was in fact correct and proceeded to posit reasons why he believed NYRA's takeout rates could not be lowered at that time. When asked about this email exchange, Hayward questionably testified that he only had focused on the portion of the email stating that NYRA could request a takeout rate reduction from the Racing and Wagering Board and had failed to read the email in its entirety. Regardless of the veracity of this representation, Hayward was, at best, careless in his reading of this email. More significantly, Hayward was derelict in his duties in failing to take note of NYRA's

[1] Effective February 1, 2013, the New York State Racing and Wagering Board was subsumed by the New York State Gaming Commission.

noncompliance with the statutory takeout rate for exotic wagers – a fact plainly stated in the email.

Other departments at NYRA also failed to calendar and note the fixed takeout rate for exotic wagers. In late 2009, the finance department, headed by then Chief Financial Officer Ellen McClain, prepared a 2010 budget projection for NYRA's Board that explicitly included mention of the September 15, 2010 sunset date for the one percent increase in NYRA's takeout rates. McClain testified to the Inspector General that she did not recall the sentence in the budget projection regarding the sunset of the takeout provision but conceded that it was likely that she discussed it with the preparer of the report. She further claimed that she would not deem a late-year reduction in takeout of one type of wager to be material to the budget. In contrast, however, the member of the finance department responsible for calculating takeout projections for NYRA disagreed with McClain's assessment as to materiality of this oversight, given the revenue at stake. The finance department and McClain should have been better focused on the takeout legislation because takeout is NYRA's major source of revenue.

NYRA's simulcasting department, which routinely deals with takeout rates, also missed an opportunity to identify NYRA's noncompliance with the exotic wager takeout rate. Simulcasting is the transmission of live races to various sites for wagering. Takeout rates affect simulcasting contracts because the simulcasting sites, with certain exceptions, must charge the same takeout rate for NYRA races they are simulcasting as NYRA charges for on-track wagering. As such, part of every simulcast contract includes a list of the takeout rates then in effect. When the Legislature imposed on NYRA the one percent increase in takeout rates, NYRA's simulcasting department renegotiated with most of its simulcast sites to split the one percent increase. The simulcasting contracts even note the September 2010 sunset date. While

the preponderance of the blame regarding the takeout overcharge that occurred at NYRA rests with the law department, and specifically Kehoe, it is clear that others at NYRA were provided the law and neglected to read and analyze its details.

Former NYRA Board members also exhibited a limited focus on the legislation, the fixed takeout rate for exotic wagers, and the sunset date in varied testimony, either failing to specifically recall the one percent increase and sunset provision; denying knowledge of the sunset provision; denying awareness of the 26 percent fixed rate for exotic wagers; or denying awareness of the 2008 legislation at all. Given the importance of the 2008 legislation and the increase to NYRA's takeout rates, more attention should have been paid to the legislation particularly as it pertained to takeout rates, the lifeblood of NYRA's finances, at least enough to have inquired of Hayward and Kehoe of its status around the time of the sunset date of September 15, 2010.

The Audit Committee of NYRA's Board at the time also failed in its duties. According to its Charter then in effect, the Audit Committee was required to meet at least annually with NYRA's counsel to review "any legal matters that could have a significant impact on the organization's financial statements [and] NYRA's compliance with applicable laws and regulations." The Audit Committee also supervised NYRA's internal audit department. James Heffernan was the chair of the Audit Committee from October 2008 to the end of 2010. When asked what he thought should have been done by NYRA's internal audit department regarding the takeout rate, Heffernan stated that the internal audit department should have been contacting the law department "on a regular basis" to determine whether it had "reviewed the statute that went through all the takeout rates and signed off on it." It was the Audit Committee chaired by Heffernan, however, that was tasked with meeting with counsel and failed to do so, and the

Audit Committee that repeatedly approved the audit plans each year from 2008 to 2011, yet failed to require any such review of takeout rates.

According to the 2008 Charter of NYRA's internal audit department, its mission was to provide the Board of Directors and the Audit Committee with "reasonable assurance" that "NYRA's established policies and procedures are adequate, are being adhered to, and that these policies and procedures enable NYRA to achieve its goals." The Director of Internal Audit was required to establish a yearly audit plan to be approved by the Audit Committee. The internal audit department was specifically directed to include in its audit scope the integrity of internal controls relating to operating and financial information as well as statutory and regulatory compliance. The Inspector General determined, however, that until the takeout issue was exposed in December 2011, no one in NYRA's internal audit department even reviewed the takeout rates, let alone conducted any audit to assess their accuracy.

Not only did the internal audit department fail to review the takeout rate, it similarly failed to review the internal controls of the law department whose duties specifically included statutory compliance. One former internal auditor stated that NYRA had no controls in place to ensure that the correct takeout rates were being charged. If the internal audit department had reviewed the law department's internal controls, it would have found, as the Inspector General did, that no system was in place to periodically check compliance with statutory rates or to properly calendar important legislative dates like the sunset provision relating to takeout rates.

In addition, after the death of the Director of Internal Audit in June 2011, NYRA did not appoint a new Director of Internal Audit. Instead, the management of the internal audit department was assumed by then CFO McClain. This structure was contrary to the Audit Committee Charter and the standards of the Institute of Internal Auditors which requires internal

audit to be structurally independent from management. McClain's involvement in internal audit department functions was pervasive: she became involved in the performance reviews of internal audit department staff and dismissed at least one employee, which left a staff of two; she reviewed Audit Committee minutes before they were provided to committee members; she oversaw the search for an outside company to perform the internal audit function in the wake of the director's death; and she directed the activities of Deloitte & Touche, LLP, once they were retained, to re-vamp the internal audit department, and then required that the subordinate staff report to an on-site Deloitte employee. These actions were all inappropriate given the mandate of the internal audit department.

With regard to an external auditor, pursuant to the Racing, Pari-Mutuel Wagering and Breeding Law (Racing Law), NYRA is required to retain a certified public accountant to audit NYRA's year-end financial statements and to render an opinion regarding the efficacy of NYRA's system of internal controls. From 2005 until the end of the audit work that includes calendar year 2011, UHY, LLP was retained as the external auditor for NYRA. Although UHY performed compliance audits, financial audits, and tax work for NYRA, it failed to uncover that NYRA was out of compliance with the statutory takeout rate at issue as well as tax rates and breeders' fund contributions, because it relied solely on NYRA for information as to the correct statutory takeout rates when other options were readily available – a practice contrary to standard accounting principles. The Inspector General determined that UHY's compliance audits failed to achieve their stated objectives. The Inspector General further determined that, with regard to the yearly audit of NYRA's financial statements, UHY failed to engage in an audit sufficient to test the accuracy of NYRA's revenue and statutory payment calculations which underlie its financial statements.

NYRA employs a totalisator company to electronically combine its bets into pools and calculate odds and projected payoffs. For the period relevant to this investigation, NYRA contracted with United Tote for totalisator services. The Inspector General found no wrongdoing with United Tote. However, the Inspector General found fault with United Tote's external auditors. Berry Dunn McNeil and Parker (Berry Dunn) was United Tote's external auditor until late 2010. Regarding whether the takeout rates were properly set in the configuration report, Berry Dunn admitted that it did nothing to test whether the takeout rates conformed to New York statutory requirements. While Berry Dunn's testing examined whether required reports, including configuration reports, were generated for NYRA by United Tote, it did not examine whether the takeout rates in those reports were set "in accordance with NY requirements" as it claimed in its October 2010 report. Berry Dunn admitted to the Inspector General that it did not verify that the takeout rates programmed in United Tote's system conformed to New York State statutory requirements.

In 2010, United Tote's parent company merged into Churchill Downs, Inc. For the report ending September 30, 2010, United Tote permitted Berry Dunn to complete the review that had already commenced. After that report, United Tote engaged PricewaterhouseCoopers (PwC), Churchill Downs' auditors, to perform the totalisator audit. While the PwC auditors accessed the correct statute with the correct rates, their analysis was inadequate to uncover the takeout rate error. Despite the fact that United Tote retained "file drawers full of the returns," the PwC partner in charge did not look at the returned configuration reports because he unilaterally decided that the control belonged to NYRA, not United Tote. When confronted with this statement, United Tote's president denied this assertion and stated, "I assumed that they would validate the takeout rate" as part of the engagement. Based on the interviews of PwC's two on-

site auditors, the Inspector General determined that PwC failed to conduct a thorough review of the takeout rates.

The Racing and Wagering Board similarly failed to identify NYRA's takeout overcharge and to monitor the expiration of the takeout legislation. While the evidence indicates that the Racing and Wagering Board's legal department read and analyzed the statute, former Racing and Wagering Board Counsel Robert Feuerstein conceded that he did not calendar the sunset date and that he was primarily "responsible for legislative matters and these types of things." As a result, no one at the Racing and Wagering Board realized when the legislation expired. The Inspector General determined that when the takeout rate reverted, the Racing and Wagering Board did not have a process in place to regularly compare the statutory takeout rate to the rate in effect.

In 2012, New York State enacted legislation that created the New York State Gaming Commission to, among other objectives, promote integrity and transparency in gaming. The Gaming Commission, which became effective on February 1, 2013, supervises all areas of gaming in New York State. According to its legislative intent, the Gaming Commission was designed to consolidate the state's gaming regulatory functions into a single oversight body so as to achieve strict state regulation of all corporations, associations and persons engaged in gaming activity. The merger was also intended to increase efficiency, reduce costs and eliminate unnecessary redundancies in regulation. The new entity's goals include conducting gaming of the "highest integrity, credibility and quality" and ensuring the exclusion of unsuitable persons or entities from participating in state gaming activities. In addition, on July 30, 2013, Governor Andrew M. Cuomo signed into law the Upstate New York Gaming Economic Development Act,

which, among other mandates, authorizes a state gaming inspector general to prevent corruption at the Gaming Commission.

II. INTRODUCTION AND BACKGROUND

A. Horse Racing in New York State

Horse racing in New York State includes both thoroughbred racing and harness racing. Thoroughbred racing refers to events where a jockey rides atop a thoroughbred horse. In harness racing, which is also known as standardbred racing, a driver follows behind the horse in a sulky, a lightweight cart with two wheels, which is attached to the horse by use of a harness, giving the sport its name. New York State is the site of seven harness racetracks and four thoroughbred racetracks. NYRA operates the three major thoroughbred racetracks in New York State: Aqueduct, Belmont, and Saratoga.[2] Horse racing is a type of pari-mutuel betting. A pari-mutuel system pools all bets, and it is this aggregate of bets that determines the odds and payoffs calculated only at the close of betting.

B. The New York Racing Association, Inc.

Since 1955, the New York State Legislature has awarded to the New York Racing Association, a not-for-profit association, the exclusive franchise to conduct racing and pari-mutuel betting at Belmont Park, Aqueduct Racetrack, and Saratoga Race Course. Subsequently, these franchise rights were expanded to include legislative authorization for the granting of a license to operate video lottery terminals, or VLTs, at Aqueduct Racetrack. In 2003, NYRA reached an agreement with a gaming entity to install 4,500 VLTs at Aqueduct.[3]

Shortly thereafter, on December 4, 2003, NYRA was indicted by the United States Attorney's Office for the Eastern District of New York for crimes including conspiracy to defraud the United States and aiding and abetting false tax returns. On December 10, 2003,

[2] The fourth thoroughbred track, Finger Lakes Casino & Racetrack located in Farmington, New York, is owned and operated by Delaware North Companies.

[3] Delays due to NYRA's indictment and bankruptcy led to the abandonment of the VLT project by the gaming entity in 2007.

NYRA accepted responsibility for the conduct alleged in the indictment and entered into a Deferred Prosecution Agreement on condition that it would undertake various reforms and remedial measures under the supervision of a court-appointed monitor, the law firm of Getnick & Getnick. The indictment was ultimately dismissed in September 2005. On November 2, 2006, NYRA filed for bankruptcy. Additionally, while NYRA waited for state approval to operate VLTs at Aqueduct, loans were extended to NYRA to help keep it solvent until revenue could be generated from VLTs at Aqueduct Racetrack.

In September 2007, Governor Eliot Spitzer recommended that NYRA be awarded the franchise. As this recommendation was non-binding, the Legislature had to agree to the plan and negotiate the issues. In the interim, because NYRA's franchise was scheduled to expire on December 31, 2007, the Legislature temporarily extended NYRA's franchise and a new state overseer, the Franchise Oversight Board, was created to monitor NYRA.[4]

In early 2008, NYRA, which was then still in bankruptcy, exerted its claim of ownership of the land on which the three thoroughbred racetracks had been built, thus raising an enormous obstacle for any franchisee other than NYRA to operate the tracks, and creating the specter of potential protracted litigation over property rights. In February 2008, it was agreed that NYRA would surrender its claim of title to the three tracks vesting clear ownership to New York State, and, in return, NYRA would receive a new 25-year racing franchise, and a $105 million loan from the state so that NYRA could emerge from bankruptcy.[5] As part of the bankruptcy settlement, approximately $259 million that NYRA owed to the state would also be forgiven.

[4] Racing, Pari-Mutuel Wagering and Breeding Law § 212, which created the new Franchise Oversight Board, became effective on the date of the "substantial consummation of plan of reorganization." Prior to that, the Non-Profit Racing Association Oversight Board had been active since July 2005.

[5] NYRA would be required to repay the loan out of VLT proceeds when a racino was in operation at Aqueduct. It was not until October 28, 2011, that the Resorts World Casino New York City was opened at Aqueduct Racetrack.

On September 12, 2008, a settlement agreement was entered into by New York State, NYRA, the Franchise Oversight Board, and the New York State Division of the Lottery, which executed the franchise agreement.[6]

Chapter 18 of the laws of 2008, which was signed into law on February 19, 2008, codified this agreement. It amended both New York State Racing, Pari-Mutuel Wagering and Breeding Law (the Racing Law) and Real Property Tax Law and had manifold stated aims relevant to NYRA, including, but not limited to: codifying the franchise agreement with NYRA, restructuring a new NYRA Board, acquiring the lands upon which the NYRA race tracks stood, creating the Franchise Oversight Board, and funding the construction of Video Lottery Terminals (VLTs) at Aqueduct Racetrack.

The legislation restructured NYRA's Board of Directors[7] to include 25 directors: 11 appointed by the former Board, seven appointed by the governor, two appointed by the temporary president of the senate, and two appointed by the speaker of the assembly. NYRA's Board included numerous subcommittees: audit, compensation, executive, facilities, finance, nominating and corporate governance, racing, and special oversight.

For the period relevant to the instant investigation, NYRA's executives included President and Chief Executive Officer Charles Hayward, Chief Operating Officer Hal Handel, General Counsel Patrick Kehoe, and Chief Financial Officer Ellen McClain.[8]

[6] The awarding of the Aqueduct Racetrack VLT franchise was not part of this agreement.
[7] The Board established through this legislation was in place for the period relevant to the instant investigation. In June 2012, legislation was enacted that disbanded this Board and created a NYRA Reorganization Board, discussed later in this report and referred to as such. The Board referred to throughout this report is the one created by the February 2008 legislation.
[8] McClain was hired in September 2009 as NYRA's Chief Financial Officer. In October 2011, after Handel left NYRA, McClain was elevated to Chief Operating Officer. McClain resigned her position effective April 30, 2013. Subsequently, NYRA was overseen by a three-person team comprised of Senior Vice President and Chief Financial

C. The Franchise Oversight Board

The Franchise Oversight Board, created by statute in February 2008, became effective on April 1, 2008, upon the completion of NYRA's plan of reorganization. The Franchise Oversight Board's responsibilities and duties include, but are not limited to, overseeing NYRA's finances, budgets, and internal controls; "Monitor[ing] and enforce[ing] compliance with definitive documents that comprise the franchise agreement," and "review[ing] such franchise corporation's compliance with the laws, rules and regulations applicable to its activities." The Franchise Oversight Board consists of five members, all appointed by the governor to four-year terms without compensation. The Board's Chair is designated by the governor.[9] As relevant to the period covered in this investigation, the Franchise Oversight Board consisted of Chair Robert L. Megna,[10] who is also the New York State Budget Director, and members Richard Aurelio,[11] John Crotty,[12] Steven Newman, and Gordon Medenica,[13] who was also the Director of the New York State Division of the Lottery until his retirement in August 2012. The current members include Robert Williams, who serves as Chair, James T Towne, Jr., Joseph Rabito, Elizabeth Garvey and Steven Newman.

Officer Susanne Stover, Vice President of Racing Facilities and Racing Surfaces Glen Kozak and Vice President of Corporate Development David O'Rourke until June 18, 2013, when the NYRA Board chose Christopher Kay as President/CEO.

[9] Pursuant to Racing, Pari-Mutuel Wagering and Breeding Law § 212(1), one of the five Board members is appointed upon the recommendation of the Senate and one upon the recommendation of the Assembly.

[10] Megna resigned from the Franchise Oversight Board in October 2012. He currently serves on the NYRA Reorganization Board.

[11] Aurelio resigned from the Franchise Oversight Board on July 10, 2013.

[12] Crotty's membership on the Franchise Oversight Board expired on May 16, 2013. He currently serves on the Gaming Commission.

[13] Medenica resigned from the Franchise Oversight Board in July 2012.

D. The New York State Racing and Wagering Board

Established in 1973, the New York State Racing and Wagering Board, until the creation of the Gaming Commission in February 2013, was charged with regulating all legalized pari-mutuel operations, charitable gaming, and Class III Indian gaming in New York State. The Racing and Wagering Board's stated mission was to ensure integrity and compliance with state statutes, its own rules and gaming compacts. The Board consisted of three members appointed by the governor by and with the advice of the senate. Its chair was designated by the governor. During the time period relevant to this investigation, the Racing and Wagering Board consisted of Chair John D. Sabini and members Daniel D. Hogan and Charles J. Diamond.

Pertinent to this investigation, the Racing and Wagering Board maintained "jurisdiction over all horse racing activities and all pari-mutuel betting activities, both on-track and off-track, in the state and over the corporations, associations, and persons engaged therein." Further, the Racing and Wagering Board possessed civil enforcement authority to ensure that racing associations operated within the parameters of the New York State Racing Law and rules promulgated by the Racing and Wagering Board.[14] Accordingly, the Racing and Wagering Board regulated 16 pari-mutuel operations throughout the state: seven harness racetracks, four thoroughbred racetracks, and five off-track betting corporations.[15] The Racing and Wagering Board maintained four offices and also had offices located at each casino and racetrack subject to its authority. As operator of three thoroughbred racetracks in New York State – Aqueduct Racetrack, Belmont Park, and Saratoga Race Course – NYRA was subject to regulation by the Racing and Wagering Board.

[14] All of the statutes and rules were accessible on the Racing and Wagering Board's website, and are now accessible on the Gaming Commission's website.

[15] The Racing and Wagering Board also oversaw various breeding funds and entities who received monies from betting at racetracks.

With regard to licensing, the Racing Law mandates that "any non-franchised corporation[s]," individuals and associations who conduct or participate in pari-mutuel activities must obtain a license from the Racing and Wagering Board.[16] NYRA, a franchised corporation, is specifically excluded from this licensing requirement. However, all NYRA Board members, employees and vendors had to be licensed by the Racing and Wagering Board.

Historically, the extent of the Racing and Wagering Board's oversight of NYRA varied as a result of statutory changes in the law. Prior to 2008, NYRA's financial practices were closely monitored by the Racing and Wagering Board. For example, the Racing and Wagering Board possessed the authority to approve NYRA's auditor, and review and approve NYRA's annual financial statements. In addition, NYRA was required to submit all of its internal policies – including its internal controls, audit policies, and accounting policies – to the Racing and Wagering Board for approval.

However, as a result of the 2008 franchise agreement and resulting legislation, many of the financial oversight responsibilities formerly charged to the Racing and Wagering Board were transferred to the Franchise Oversight Board, as discussed above. Despite these changes, the Racing and Wagering Board maintained its authority over the disposition of pari-mutuel pools and totalisator company[17] audit standards. Included in these responsibilities and pertinent to the instant investigation, the Racing and Wagering Board was also responsible for approving NYRA's takeout rates.

[16] Racing, Pari-Mutuel Wagering and Breeding Law § 205.

[17] A totalisator company employs a totalisator system to monitor pari-mutuel betting. A totalisator is the network of computers and betting terminals that electronically combine the bets into pools and recalculate odds and projected payoffs until the wagering pool is closed at the start of a race. Once race results are official, the totalisator calculates the payoffs. The Racing and Wagering Board licenses all totalisator companies in New York State. The conditions of a totalisator license require totalisator companies to annually submit an audit report to the Racing and Wagering Board which demonstrates its compliance with New York State standards.

E. The Statutory Development of NYRA's Takeout Rates

Horse racing is a type of pari-mutuel betting. A pari-mutuel system pools all bets, and it is this aggregate of bets that determines the odds and payoffs calculated only at the close of betting.[18] In contrast, in fixed-odds betting, the payout is agreed upon at the time the bet is placed and does not change. Simply put, in pari-mutuel betting, a gambler bets against other gamblers, while in fixed-odds betting, the gambler bets against the house. "Handle" is the term for the total dollar amount of the bets wagered. The track and the off-track betting site that is simulcasting the race retain a certain percentage of handle depending on the type of bet. This percentage is called the "retention rate," commonly referred to as "takeout." Takeout is the income that funds the daily operations of the tracks and the simulcasting sites.[19]

The takeout rates for horse racing in New York State are dictated by statute. Prior to 2003, the statutes set fixed takeout rates depending on the type of wager. As such, tracks had no discretion as to the takeout rate charged for each wager.[20] Effective May 2003, the Racing Law permitted ranges of takeout rates among the different wagers.[21] For instance, while the takeout rate for "regular" bets prior to 2003 was set at 17 percent, the 2003 legislation permitted a range of between 12 and 17 percent. The following table depicts the changes enacted by the 2003 legislation:

[18] The pool is also referred to as the "tote," because a system called a "totalisator" calculates and displays the bets already made.
[19] Pursuant to statute, NYRA pays certain taxes from the takeout it generates.
[20] The takeout rates for NYRA tracks as compared to those for Finger Lakes, the other thoroughbred track in the state, are governed by different statutes. Finger Lakes is permitted higher takeout rates.
[21] Racing, Pari-Mutuel Wagering and Breeding Law §229.

Type of Bet	Pre-2003	2003
On-track Regular	17	12-17
On-track Multiple	17	14-21
Exotics	25	15-25
Super exotics	36	15-36

Accordingly, after the 2003 legislation, NYRA had the ability to decide what takeout rates to charge its customers within the prescribed range of rates. However, the law also mandated that any change in takeout rates required the approval of the Racing and Wagering Board and could only be requested quarterly to be effective the next quarter. The ranges of rates remained the same even after new legislation was enacted in February 2008 incorporating NYRA's new status as a franchisee of the state.[22]

June 2008 Legislation

Just a few months later, in June 2008, legislation was enacted that, among other mandates, changed the rates that NYRA could charge. The legislation was enacted to help the New York City Off-Track Betting Corporation (NYC OTB), which was at risk of being closed. Mired in a dire financial situation – NYC OTB faced approximately $200 million in outstanding liabilities – the City vowed to shutdown NYC OTB rather than subsidize it. In response, legislation was enacted that changed the composition of NYC OTB's board to shift control to the state. In addition, and pertinent to the instant investigation, the new legislation effectively increased the takeout rate for all NYRA races by one percent. This legislation was enacted to increase revenue to the ailing NYC OTB, because, after the payment of certain minor fees, the

[22] When legislation was enacted in February 2008 to incorporate NYRA's reorganization and the new franchise agreement, the section under the Racing Law controlling the takeout rates was changed from section 229 to section 238.

OTBs retain the same takeout rate as the tracks at which the races take place. As explained in the purpose section of the new legislation: "This bill provides for an immediate State takeover of the New York City Off-Track Betting Corporation (NYC OTB) and creates new revenues for two years to stabilize the financial position of NYC OTB." (Parenthetical in original)

Not only did the legislation create a one percent increase in the takeout rate on all wagers placed on races run on NYRA tracks, but also, importantly, included a sunset provision that the increase would expire after two years, on September 15, 2010. With regard to the inclusion of a sunset provision, an article in the *Daily Racing Form* entitled, "OTB bill boosts simulcast takeout," quoted a staff member of a legislator who worked on the bill: "We're not proud of it. We were really in a box as far as OTB goes. We needed to get money into the OTB and we needed to do it quickly. We really didn't want to do it, and that's why we put the sunset provision in place."[23]

In fact, many NYRA Board members and executive staff were opposed generally to any increase in takeout, and believed that a decrease in takeout over time would significantly increase handle, resulting in an overall increase in takeout revenue for NYRA. As NYRA's former CEO and President Charles Hayward explained to the Inspector General:

> [T]he biggest problem we have is that we are not competitive from a gambling perspective. Our blend[ed] takeout in the industry was about 20 percent.[24] You go to a casino, you bet on slots, they're about 9 percent; table games, 2 or 3 percent; sports banks, 5 percent. And aggressive New York State, when they had the opportunity to put [video lottery terminals] in, they obviously understood the elasticity and sensitivity of takeout because the slots are 9 percent. If you charge 20 percent takeout in a slot parlor after a month, you'd be out of business because no one would be coming back because you're pulling too much money out of that to allow them to have a good experience, to give them enough residual money, to have a good time and to want to come back.

[23] "OTB bill boosts simulcast takeout," by Matt Hegarty, *Daily Racing Form*, June 18, 2008.
[24] "Blended takeout" is an average of the different takeout rates.

OTBs across the state disagreed with this position and lobbied heavily for increases in takeout rates. The OTBs support increases in takeout rates because, after paying a certain small percentage to the host tracks for the right to simulcast the races, OTBs retain the remainder of the charged takeout rate.[25] Therefore, when this attempt was made to save NYC OTB, the OTBs lobbied for a one percent increase in the takeout rate for NYRA races, and this increase was eventually enacted.

The details of the one percent increase are indicated in the following chart:

Type of Bet	**Takeout Range**	**NYRA Takeout Rate (2008)**	**June 2008 Legislation**
On-track Regular	12-17	15	16-17
On-track Multiple	14-21	17.5	18.5-21
Exotics	15-25	25	26
Super exotics	15-36	15	16-36

As noted, because the legislation governing NYRA takeout permitted a range among the varying wagers, NYRA was able to choose any takeout rate within that range. As the above chart delineates, NYRA's takeout rate prior to the June 2008 legislation was in the middle of the range for on-track regular bets and on-track multiple bets; it was at the top of the range for exotics; and, it was at the bottom of the range for super exotics. The Legislature accordingly raised the floor on the range of takeout rates for on-track regular, on-track multiple and super exotic bets to impose the one percent increase. With regard to the exotic takeout rate, however, NYRA was already employing a takeout rate at the top of that range. Therefore, in contrast to the other types of wagers, the Legislature imposed a fixed rate of 26 percent for exotic bets.

[25] The OTBs also charge a five percent surcharge on all bets, therefore retaining an additional amount of bettors' winnings.

NYRA's former legislative counsel and lobbyist William Y. Crowell III, of Whiteman, Osterman & Hanna, LLP, testified that while NYRA generally was opposed to higher takeout rates, the one percent increase was considered the lesser of two evils. He explained that in the face of the closure of NYC OTB (and the resulting loss of significant revenue that NYC OTB generated for NYRA) versus a state-run NYC OTB and increased takeout, NYRA favored the latter.

Former NYRA General Counsel Patrick Kehoe testified that he had discussions with Crowell about this pending legislation. Kehoe explained that part of his concern regarding the imposed one percent increase was that, based on his experience with the Racing Law, sunset provisions did not sunset and were usually extended each year. Review by the Inspector General of numerous racing statutes that include sunset provisions substantiated Kehoe's assertion. He and others at NYRA, therefore, viewed this imposed one percent increase as essentially permanent.

Perhaps this perception is why neither Kehoe nor Crowell made a written notation of this sunset date in work calendars; neither did anyone else in the law department or other departments at NYRA. More significantly, however, even if they had calendared the date, the investigation revealed that NYRA did not understand or appreciate the implications of the sunset provision related to the fixed 26 percent takeout set for exotic wagers, at least at the time the sunset provision was triggered and, in some instances, ever. Therefore, when the statute did expire and the takeout rates reverted to the pre-June 2008 rates, NYRA was operating under the misimpression that *all* the takeout rates *could* be lowered, and not that the *exotic* takeout rate *must* be lowered to ensure compliance with the law. Due to this negligence of NYRA executive management, after September 15, 2010, NYRA did not lower its exotic takeout rate and was out

of compliance with the law until late December 2011 when the overcharge was discovered by the Office of the State Comptroller.

F. Discovery of the Improper Takeout Rate for Exotic Wagers Charged by NYRA

On or about December 6, 2011, the Office of the State Comptroller, during an audit of the New York State Thoroughbred Breeding and Development Fund, contacted the State Racing and Wagering Board to inquire as to the proper percentage required to be paid to the Breeding and Development Fund. As a corollary to that inquiry, the State Comptroller also questioned whether NYRA was retaining the correct takeout rates under the law. The Racing and Wagering Board reviewed the matter and determined that NYRA's imposed exotic wager takeout rate was in excess of statutory limits. Specifically, NYRA was charging 26 percent for exotic wagers when the law, since September 15, 2010, only permitted a takeout rate for exotic wagers within the range of 15-25 percent. On December 8, 2011, the Racing and Wagering Board informed NYRA of its analysis of the law governing NYRA's takeout rates. Although initially NYRA reported that it believed it was in compliance with current takeout provisions, on December 15, 2011, NYRA concurred with the Racing and Wagering Board's determination that, in fact, the 26 percent takeout rate it was charging for exotic wagers was outside the parameters of the law.

Over the next few days, NYRA formulated a plan to lower the takeout rate for exotic wagers and to commence the process for identifying and providing restitution to the affected bettors. Initially, on December 21, 2011, NYRA submitted a written request to the Racing and Wagering Board to lower its exotic bet takeout to 24 percent[26] – an additional percentage point lower than legally required. NYRA then attempted to identify those bettors who had been

[26] NYRA also lowered the takeout rates from 26 to 24 percent on super exotic wagers, which involve multiple-race bets where the races included in the wager span two consecutive racing days.

wrongfully charged an additional one percent takeout on exotic wagers for the 15-month period of September 16, 2010, to December 2011. NYRA determined that it had incorrectly withheld $1,140,622 for on-track wagers, and $6,221,100 had been erroneously retained by racetracks and off-track betting sites. NYRA was able to identify and repay $611,604 to NYRA bettors who had wagered through the NYRA Rewards program or who had received a tax document memorializing the payout.

Also on December 21, 2011, the Racing and Wagering Board, at the request of the New York State Franchise Oversight Board, commenced an investigation into the circumstances surrounding NYRA's failure to comply for 15 months with the law as to the takeout rate for exotic wagers. Then Franchise Oversight Board Chair Robert Megna directed the Racing and Wagering Board to determine who was responsible for the takeout overcharge and why audit standards and internal controls failed to prevent or uncover the noncompliance.

On April 26, 2012, the Racing and Wagering Board Audits and Investigations Unit issued a report to the Franchise Oversight Board entitled, "Interim Report into the Matter of Incorrect Takeout Rates at the New York Racing Association, Inc." The Interim Report concluded, among other things: "The documentation received from NYRA indicates a knowledge of the violation [by executive management and a] failure to report that information in a timely fashion and take corrective action." In contrast to the Racing and Wagering Board's conclusions delineated in its Interim Report, NYRA had reported to the Racing and Wagering Board that any noncompliance with the takeout law was an "inadvertent error" and a "mistake."

On April 29, 2012, then Franchise Oversight Board Chair Megna requested that the State Inspector General conduct a review of the matter, resulting in the Inspector General commencing this investigation.

On April 30, 2012, NYRA suspended its President and CEO, Charles Hayward, as well as its General Counsel, Patrick Kehoe. Their employment with NYRA was then terminated on May 4, 2012.

G. Inspector General's Jurisdiction

Executive Law Article 4-A authorizes the Inspector General to "receive and investigate complaints from any source, or upon his or her initiative, concerning allegations of corruption, fraud, criminal activity, conflicts of interest or abuse in any covered agency," and to "review and examine periodically the policies and procedures of covered agencies with regard to the prevention and detection of corruption, fraud, criminal activity, conflicts of interest or abuse." The Racing and Wagering Board, which regulated NYRA, and the Franchise Oversight Board, which oversees it, are within the Inspector General's direct jurisdiction.

Pursuant to Executive Law Article 4-A, "covered agencies" within the Inspector General's jurisdiction comprising "all executive branch agencies, departments, divisions, officers, boards and commissions, public authorities (other than multi-state or multinational authorities), and public benefit corporations, the heads of which are appointed by the governor and which do not have their own inspector general by statute," are required to provide documents and witnesses to the Inspector General without resort to a subpoena. The Inspector General also possesses the authority to issue subpoenas in furtherance of an investigation. Indeed, this authority is explicitly enumerated in Executive Law § 54, which provides the Inspector General

with the power to "subpoena and enforce the attendance of witnesses" and "require the production of any books and papers deemed relevant or material to any investigation, examination or review." Accordingly, the Inspector General issued letter requests to governmental entities and subpoenas to non-government entities to obtain relevant materials, which resulted in the examination of over 800,000 document pages. The Inspector General also interviewed 60 individuals in 68 interview sessions.[27]

[27] A number of witnesses were interviewed more than once.

III. INVESTIGATION

A. The NYRA Law Department, Legislative Counsel and President/CEO

Because this investigation examines statutory noncompliance by NYRA, the Inspector General looked first at NYRA's law department.

The Structure of the Law Department

From July 1, 2002 until May 4, 2012, NYRA's law department was headed by General Counsel Patrick Kehoe. Prior to assuming that position, Kehoe was an Assistant Counsel to Governor George Pataki charged with the governor's racing and wagering portfolio. As NYRA's General Counsel, Kehoe also maintained the titles of NYRA Senior Vice President and Corporate Secretary. As Senior Vice President, Kehoe was involved in legal as well as larger management issues at NYRA. In fact, Kehoe's office was located in the executive suite and not in the law department. As Corporate Secretary, Kehoe was tasked with keeping the minutes of the board meetings and acted as the contact person at NYRA for the board members. Kehoe testified that he interacted with former Chairman of the Board C. Steven Duncker,[28] former Vice Chair James Heffernan[29] who headed the Special Oversight Committee which oversees the business integrity counsel, and former Vice Chairs Stuart Subotnick and Michael Del Guidice, as well as other board members who chaired committees.

During Kehoe's tenure, NYRA also employed Assistant General Counsel Pasquale Viscusi, two associate counsels, one paralegal and two administrative staff. One associate counsel dealt mainly with labor disputes; the other associate counsel handled litigation. Viscusi managed the day-to-day operations of the law department and reported to Kehoe. For instance,

[28] Duncker's term as a NYRA Board Member expired on September 11, 2012; however, he is currently a member of the new NYRA Reorganization Board.
[29] Heffernan's term as a NYRA Board member expired on September 4, 2012, and he resigned his membership.

Viscusi was the main contact with the State Racing and Wagering Board. He also drafted and negotiated contracts, attended meetings regarding procurements, conducted labor arbitrations, and occasionally attended labor negotiations. During the period at issue, Viscusi held several titles in addition to Assistant General Counsel: Anti-Money Laundering Compliance Officer,[30] Ethics Officer,[31] and Regulatory Compliance Officer. Although charged with these enumerated duties, when queried by the Inspector General about the attendant responsibilities, Viscusi minimized his roles and provided questionable reasons for his failure to perform the responsibilities that accompanied them.

As this investigation is examining NYRA's 15-month non-compliance with the statutory takeout rate for exotic wagers, the Inspector General was specifically interested in Viscusi's duties and responsibilities as Regulatory Compliance Officer. In general, the term regulatory compliance encompasses the objective that corporations or public agencies strive for in their efforts to ensure that personnel are aware of and take steps to comply with relevant laws and regulations. In order to maintain regulatory compliance, many corporations and agencies utilize compliance controls. In fact, NYRA's Law Department Policies and Procedures states: "The General Counsel will make a diligent effort to identify those laws, rules and regulations . . . which pertain to NYRA's operations, and inform NYRA management of its responsibility to comply." Viscusi, however, was quick to dispel the notion that NYRA had a regulatory compliance program. He asserted:

> We did not have an affirmative regulatory compliance program where I ran around from office to office making sure everybody at NYRA every moment was doing every possible thing that they should be doing compliance for. I mean

[30] The USA PATRIOT Act requires that NYRA establish a formal anti-money laundering compliance program. As anti-money laundering compliance officer, Viscusi offered that he is tasked with ensuring that the established systems to prevent money laundering at the racetrack are being followed.

[31] As Ethics Officer, Viscusi explained that he was the principal contact regarding questions about NYRA's code of ethics. NYRA also utilized an ethics panel to decide issues of potential ethical violations.

> obviously everybody at NYRA is striving to follow the law all the time. . . . If somebody raised a question about regulatory compliance, it would be directed to me for investigation. But at the end of the day, you know, Patrick Kehoe acted as regulatory compliance officer as well, all right.

Viscusi then questioned why he even was given this title: "I am not sure why [Kehoe] allowed me to use this title . . . I received a large raise four or five years ago and perhaps he felt compelled to change my title at that point, because I don't know if he felt like I can't just give this kid a bunch of money without . . ." At this point, Viscusi's attorney interjected and limited his client's testimony.

Viscusi also took pains to make clear that he did not deal with legislative issues. He asserted, and Kehoe supported this claim, that his duties did not encompass pending legislation, but rather those matters were reserved for former General Counsel Kehoe and lobbyist and legislative counsel William Crowell. Documentation, however, indicates that Viscusi often dealt with legislation once it was enacted and provided advice and direction on such legislation to various offices within NYRA.

Following the termination of Kehoe, on May 14, 2012, Kenneth Handal was hired as Acting General Counsel. At that time, Viscusi was stripped of the titles and responsibilities of ethics officer and regulatory compliance officer, and Handal assumed both roles until his departure from NYRA on October 14, 2013, the expiration of his employment agreement.[32]

Legislative Counsel William Crowell

Since the 1990s and until recently, Crowell was NYRA's legislative counsel and lobbyist.[33] As to his relationship with Crowell, Kehoe expounded:

[32] Currently, NYRA President/CEO Kay is acting as the head of the law department. Kevin Rogan is Chief Compliance Officer and Corporate Secretary.
[33] The law firm of Greenberg Traurig, LLP is NYRA's current legislative counsel.

> I worked closely with Billy Crowell. You know, NYRA is a statute driven organization. They are actually a creature of statute itself. So we would interact regularly. There were constantly issues pending before the legislature that would impact upon racing in general or NYRA in particular. Billy would track those for us. We would discuss them. We would discuss the impacts of those. We would discuss which things would be helpful, which things would not be helpful.

When the Legislature was in session, Crowell would send legislative and regulatory updates at least weekly and often daily. Kehoe explained that Crowell's longtime assistant would periodically send emails to Kehoe regarding pending legislation that she believed were relevant to NYRA or racing. She would provide the bill number, a brief summary of what the bill addressed, and its status.

Legal Counsel's Awareness of the 2008 Legislative Changes to NYRA's Takeout Rates and Failure to Track Compliance

On June 17, 2008, Chapter 115 of the Laws of 2008 was signed into law and, on June 18, 2008, Crowell's assistant emailed Kehoe a copy of the newly enacted legislation, which included the mandated changes to NYRA's takeout rates. The attached legislation was 14 pages long but the changes to the various sections of the law were printed in bold. Notably, the changes to the takeout rates that NYRA could then charge, and specifically the fixed 26 percent rate for exotic wagers, appeared on page two highlighted in yellow. Despite the bold print and the yellow highlight, Kehoe apparently failed to review the legislation upon enactment.

The law department missed other opportunities to uncover this takeout rate issue. Kehoe testified that while he was aware "generally" of the one percent statutory increase when it was enacted in June 2008, the sunset provision "was not something I was focused on at the time." Viscusi testified that he was aware of the one percent increase and that Kehoe had informed him

of the sunset provision. The investigation demonstrates that Viscusi did in fact review the legislation specific to the increases in takeout.

For instance, on June 30, 2008, approximately two weeks after the legislation was enacted, then Counsel to the Racing and Wagering Board Robert Feuerstein sent a letter to Viscusi reminding him that increases in takeout rates require a written request to and approval of the Racing and Wagering Board. He wrote:

> Chapter 115 of the Laws of 2008 amended Section 238.1(a) of the Racing, Pari-Mutuel Wagering and Breeding Law in relation to takeout rates. Specifically, Section 238.1(b)[34] is amended effective September 15, 2008 to increase the minimum retention rates for the range of rates applicable to on-track regular, multiple, exotic, and super exotic betting pools, as well as to carried forward super exotic betting pools. The retention rate to be established is subject to prior approval of the New York State Racing and Wagering Board.

Viscusi related that upon receipt of this type of letter, his general practice was to circulate it to the relevant employees. Viscusi recalled receiving this letter, and believed he scanned it into his computer and disseminated it. The Inspector General then questioned Viscusi as to whether, when circulating the letter, he provided any explanation of the cited section of the law because the letter merely discussed that an increase had been enacted but did not state what increase was mandated. Viscusi responded that he could not recall whether he did so. He also could not recall if he looked up the cited section of the law, and testified that his general practice varied – sometimes he looked up the law and other times he did not.

He did, however, respond to the letter by formally requesting the statutorily mandated one percent takeout rate increase. In an August 13, 2008 letter to Gail Pronti, Secretary to the Racing and Wagering Board, Viscusi delineated the requested increases:

> The New York Racing Association Inc. ("NYRA") writes in response to Mr. Feuerstein's letter of June 30, 2008 and pursuant to Chapter 115, section 2(a) of the laws of 2008 to confirm that on the effective date of the Chapter, and

[34] Feuerstein incorrectly cited Section 238.1(b). The correct section is 238.1(a).

consistent with the minimum takeout rates contained therein, NYRA will adjust its takeout rates as follows:

- sixteen per centum of the total deposits in pools resulting from on-track regular bets;
- eighteen and one-half per centum of the total deposits in pools resulting from on-track multiple bets;
- twenty-six per centum of the total deposits in pools resulting from on-track exotic bets;
- sixteen per centum of the total deposits in pools resulting from on-track super exotic bets; and
- twenty-six per centum when such on-track super exotic betting pools are carried forward.

When asked from where he obtained these percentages, Viscusi testified that he could not recall who had provided the numbers to him:

> I don't know where I got th[e] numbers for that letter. I believe they came from Mr. Kehoe because typically when I write a letter to the board Mr. Kehoe contacts me and tells me what he wants written and I write it. I'm the liaison and he is in charge. I don't know where the numbers came from though.

Regardless, the language of Viscusi's letter to Pronti mirrors the language of the amended statute, suggesting that he reviewed the legislation. When asked if he had consulted the statute, Viscusi conceded that it was possible. The Racing and Wagering Board approved the rate change requests on August 28, 2008.

In addition, on August 7, 2008, approximately one week before he formally requested an increase in the takeout rate from the Racing and Wagering Board, Viscusi sent an email to NYRA President and Chief Executive Officer Hayward, Chief Operating Officer Hal Handel, Vice President of Simulcasting Elizabeth Bracken[35] and others indicating that he had been contacted by the Racing and Wagering Board that NYRA's formal request to raise takeout rates had yet to be received. He noted in the email that he had discussed the issue with Kehoe and explained, in pertinent part, "[O]ur advice is that NYRA's first step with respect to the increase

[35] Bracken resigned her NYRA employment effective August 2, 2013.

in takeout as applicable to NYRA should be to take whatever action is necessary (e.g., amending our simulcast agreements) to implement the takeout increase so that we do not run out of time to be in compliance."

On August 11, 2008, Bracken, who ran NYRA's simulcasting department, asked Viscusi for "some clarification" about the above letter from Feuerstein – an indication that Viscusi had in fact disseminated it – and the law and process in general regarding the statutorily mandated takeout increase. Viscusi responded on that same date in a lengthy email, in which he answered each of Bracken's questions separately with a detailed analysis of the statutory changes in the takeout rate and attached an excerpt of the law that specifically increased the takeout rates:

> Liz: In response to your questions:
>
> Question 1. "What exactly does this mean? Are we increasing every export takeout rate 1%?"
>
> Answer 1. No. We are not increasing every export takeout rate 1%. **Pasted at the bottom of this email is the relevant excerpt from the language of Chapter 115 regarding the new retention rates applicable to NYRA's races. Please note that, as to *most* of the wager categories, the language sets forth a range of possible retention rates.** [Emphasis supplied]
> Question 2. "It looks like the NYSRWB needs to approve the new rates before we notify the sites, and I need to know exactly what to tell the sites since we need to amend all the agreements."
>
> Answer 2.
>
> a. As to ***most*** of the wager categories (i.e., ***where a statutory range is applicable***), NYRA must decide which rate to apply within the relevant range. (I assume that NYRA will apply the minimum rate possible under the statute in each such category). [Underline in original] You should advise the NYRA simulcast affiliates in accordance with NYRA's relevant retention rate determinations, with the understanding that the NYRA retention rate determinations require NYSRWB approval. [Emphasis supplied]
>
> b. The NYSRWB is waiting for a request for approval from NYRA setting forth what retention rate NYRA will apply in each of the categories where a range is specified. I will prepare a draft letter for everyone's review in this regard.

(On a related note, FYI, Bob's letter contains a typographical error. He should have referenced 238.1(a) where he referenced 238.1(b)).

In addition to the above explanation, Viscusi attached the following excerpt of the law:

Excerpt from Chapter 115

(a) The franchised corporation authorized under this chapter to conduct pari-mutuel betting at a race meeting or races run thereat shall distribute all sums deposited in any pari-mutuel pool to the holders of winning tickets therein, provided such tickets be presented for payment before April first of the year following the year of their purchase, less an amount which shall be established and retained by such fran- chised corporation of between **[~~twelve~~]** **sixteen** to seventeen per centum of the total deposits in pools resulting from on-track regular bets, and **[~~fourteen~~]** **eighteen and one-half** to twenty-one per centum of the total deposits in pools resulting from on-track multiple bets and **[~~fifteen to twenty-five~~]** **twenty-six** per centum of the total deposits in pools resulting from on-track exotic bets and **[~~fifteen~~]** **sixteen** to thirty-six per centum of the total deposits in pools resulting from on-track super exotic bets**, and twenty-six to thirty-six per centum when such on-track super exotic betting pools are carried forward**, plus the breaks. The retention rate to be established is subject to the prior approval of the racing and wagering board.

It is clear from both the text of the email and the attached excerpt of the law specific to takeout rates that Viscusi read and understood the change in the law. Relevant to the instant investigation, he undoubtedly understood at the time he drafted this email that "most" of the wager categories included ranges – and one, the exotic wagers, did not. Viscusi even went so far as to correct the statutory citation from the letter of Racing and Wagering Board's Counsel "Bob" Feuerstein from 238.1(b) to 238.1(a), which he characterized as a typographical error. Notwithstanding this apparent legal research and analysis, Viscusi maintained to the Inspector General he did not know that the takeout rate for exotic wagers had increased from 25 percent to 26 percent, the only possibility under the law in September 2008; rather, he only could recall that the takeout rates in general were increased one percentage point. Viscusi asserted, "I am not a gambler. I don't have the numbers in my head."

Given the number of bills and legislation that relate to NYRA and the complexity of the Racing Law in general, the Inspector General inquired of Kehoe and Viscusi as to whether the law department employed a calendar or tickler system to keep track of sunset dates and/or other key dates. Kehoe explained that the law department utilized an electronic calendar system, and

at various times, he had staff insert key dates in the calendar, such as pari-mutuel taxes and annual budget deadlines to the Franchise Oversight Board. However, no one was specifically tasked with tracking legislation and inserting key dates in the calendar. Kehoe lamented: "Unfortunately for this piece of legislation [regarding the one percent increase in takeout rates] it did not go into that system. Whether it had, we wouldn't be here."

Given NYRA's consistent position against higher takeout rates, the Inspector General questioned why the sunset date was not calendared with a proverbial red "X." Kehoe responded that he viewed the increase as permanent and expected the sunset date to be extended indefinitely. He stated that he "wish[ed]" NYRA had calendared the sunset date. Notwithstanding his wishes, even if Kehoe had directed that the date be placed in the law department's calendar, the single fixed rate for exotic wagers most likely would have gone unnoted because it does not appear that he conducted any type of thorough review of the statute, and was unaware of the fixed takeout rate that had been established for exotic wagers. Kehoe, however, was aware of the sunset date. In fact, in a July 3, 2009 email exchange with Viscusi and Hayward, Kehoe listed a number of sections of the Racing Law that expired on July 1, 2009, or other dates. Kehoe wrote, "On the horizon: Section 238(1)(a) expires September 15, 2010 and is replaced by a new section (1)(a)." It is clear from this email and other documentary and testimonial evidence that Kehoe did not forget about the sunset date; rather, in direct contravention of his responsibilities as counsel to NYRA, Kehoe was derelict in his duty to track this law and ensure compliance.

As to Viscusi, as explained earlier, although he conducted a thorough review of the takeout changes in August 2008, it appears that he, too, failed to calendar the date or commit it to memory. Viscusi stated, "I don't know if anybody at NYRA that was involved with take-out had

a tickler for this. I don't know." Despite having the titles of Regulatory Compliance Officer and Assistant General Counsel, Viscusi clearly did not deem the sunset of the takeout legislation to be within his purview so as to calendar it or memorialize it in any way.

President/CEO Hayward's Awareness of the One Percent Increase in Takeout and the Sunset Provision

Hayward also was aware of both the takeout increase and the sunset provision as evidenced by a June 18, 2008 email to an interested bettor who was disgruntled about the increase. Hayward wrote, "At this point, the most important thing is that the State honor the sunset provision which is supposed to repeal the increase after 2 years. . . . As I have said numerous times, I would recommend to our NYRA Board a takeout decrease once we get out of bankruptcy and we start receiving payment from the Aqueduct VLT cash flows."

B. NYRA Board Members and Their Knowledge of the Increased Takeout Rate

Former NYRA Board members also exhibited a limited focus on the legislation, the fixed takeout rate for exotic wagers, and the sunset date in varied testimony, either failing to specifically recall the one percent increase and sunset provision; denying knowledge of the sunset provision; denying awareness of the 26 percent fixed rate for exotic wagers; or denying awareness of the 2008 legislation at all. Given the importance of the NYC OTB legislation and the increase to NYRA's takeout rates, more attention should have been paid to the legislation particularly as it pertained to takeout rates, the lifeblood of NYRA's finances, at least enough to have inquired of Hayward and Kehoe of its status around the time of the sunset date of September 15, 2010.

Hayward testified that although no written report on the increased takeout rate was created for NYRA's Board, he was confident that the takeout increase was discussed with the

members. Hayward added that the increases in the takeout rates would not have been "dwelled upon" because they were deemed to be "nonnegotiable."

The Inspector General reviewed board and committee minutes for the relevant period and found scant mention of the takeout increase absent the following. In the March 10, 2009 NYRA Board meeting minutes, the Finance Committee reported to the full Board that "the handle decline has been mitigated due to the statutory takeout increase and the NYRA simulcast rate increase." Board members confronted with this document, however, had no memory of this reference to the statutory takeout increase and explained that it would have been unremarkable at the time due to the greater significance of other financial issues.[36]

The Inspector General also showed Board members a 12-page document entitled, "2010 Budget Overview," prepared by NYRA's finance department which was headed at that time by Chief Financial Officer Ellen McClain. This budget forecast was prepared at the end of 2009 and would have been reviewed by McClain and Hayward prior to its presentation to the Board on December 2, 2009. The second page of the 2010 Budget Overview included the point, "Blended commission rates are budgeted to remain relatively flat year-over-year, and assume an extension of the 1% takeout increase enacted in September 2008 which is set to expire September 2010." None of the Board members confronted with this document recalled seeing it or noting its significance.

Given the aforementioned assumption in the 2010 Budget Overview, the Inspector General also inquired of the finance department members and McClain about their understanding of the statutorily mandated takeout rates.

[36] For instance, NYRA was concerned with the pending insolvency of NYC OTB, NYRA's largest single customer; the delay in the establishment of a VLT operator at Aqueduct; and a 7-8 percent decline in handle.

C. The Finance Department and Chief Financial Officer Ellen McClain

From August 2009 until October 2011, the finance department was headed by Chief Financial Officer Ellen McClain. Her department was charged with preparing the budgets for presentation to the NYRA Board. In the time period relevant to the instant investigation, David O'Rourke was the Director of Finance and was instrumental in the preparation of the budget.[37] When confronted with the 2010 Budget discussed above, and the specific assertion, "Blended commission rates are budgeted to remain relatively flat year-over-year, and assume an extension of the 1% takeout increase enacted in September 2008 which is set to expire September 2010," O'Rourke stated that he did not recall the specific sentence but accepted that he had seen it at the time and was involved in its crafting.

O'Rourke explained further that, having commenced employment at NYRA in May 2008, he recalled the enactment of the statute that increased NYRA's takeout and knew of the sunset date, but was totally unaware of the specifics of the takeout increase other than that it involved a one percent increase for every wager type. Specifically, he did not understand that the exotic takeout rate had been fixed at 26 percent. Therefore, he thought that whether it sunset or not, NYRA would have the ability, but not the requirement, to change the rates. He explained:

> [M]y understanding would be that the OTBs were lobbied and extended, because they benefited from this one percent, not NYRA. We, actually, would have preferred it not to, from my understanding, for it to have been increased. However, if it were to sunset, then we would have the ability to apply to change it and it's no longer locked in, but there was no understanding on my part or anyone else that I dealt with that we would have needed to move any of them for any specific reason. It was more an understanding that we would, all of a sudden, have the option to, if we chose.

[37] In September 2011, O'Rourke became "Vice President of Corporate Development." With this change, O'Rourke was no longer tasked with preparing budgets.

Unlike O'Rourke, McClain arrived at NYRA after the one percent increase in takeout legislation had been enacted. She testified to the Inspector General that she was unaware of the sunset provision of the takeout law. When shown the 2010 Budget Overview, which she was involved in preparing and which she ultimately approved, McClain stated that she had no recollection of the sentence regarding the assumption of an "extension of the 1% takeout increase enacted in September 2008 which is set to expire September 2010." The Inspector General then asked McClain if she inquired of O'Rourke at that time as to the meaning of this assumption given her testimony that she did not know of the sunset provision. McClain asserted, "I don't have a recollection. Generally we talk about these things, so I think it's more likely than not that we talked about this in passing like we talk about a lot of other things in this document." As to the merits of the inclusion of this takeout information in the 2010 Budget Overview, McClain posited, " I don't know . . . what [David O'Rourke's] thinking at the time is, it's not material to an overall budget, so I don't know what he was thinking, but he felt he needed to flag it. This would have impacted only a quarter of results in 2010, so it's not a key driver of a budget." Notwithstanding this assertion, McClain did not request that the sentence be removed as immaterial to the budget overview. Indeed, prior to its presentation to the Board, the budget overview was reviewed and approved by McClain, Kehoe and Hayward.

Moreover, Steven Hofmann, a former Revenue Analyst at NYRA and a valued member of the finance department from whom McClain regularly solicited data, disagreed with her assessment as to materiality. Hofmann was tasked with budgeting the revenue based on handle, on daily, monthly and yearly bases and analyzing trends. Contrary to McClain, Hofmann attested to the Inspector General that he considered any potential change in takeout, even occurring in September 2010, to be material to the 2010 projected budget.

Given Hofmann's position and responsibilities, the Inspector General questioned him as to whether he ever discussed the sunset provision with McClain. Hofmann testified that he recalled discussing with McClain a one percent reduction in takeout in August or September 2010 in a finance department weekly meeting. Hofmann elaborated, "there was discussion for months just between [McClain] and myself and then we reached out to [Vice President of Simulcasting] Liz Bracken." When the Inspector General asked McClain if she recalled any meetings around August or September 2010 in which an overall general reduction in takeout was discussed, she replied that she did not.

The evidence clearly supports that Hofmann understood that the takeout rates were scheduled to sunset on September 15, 2010, and that he raised the issue with Kehoe. Specifically, as part of compiling the information necessary for the 2010 Budget Overview discussed above, Hofmann inquired of Patrick Kehoe on October 27, 2009, regarding the expiration of the takeout rates. Hofmann wrote, "I am putting together budget numbers for 2010. According to the [New York State Racing and Wagering Board] web site, the current Section 238 part 1(a), takeout rates, is effective until September 15, 2010. I just want to confirm that this version is set to expire at that time." A few minutes later, Kehoe responded: "Your reading is correct. As a practical matter, these dates (and rates) are extended each year as a matter of course, but its [sic] good to keep an eye on them as well." Hofmann explained that because he did not receive any additional information, he assumed that the legislation had been extended.[38]

[38] In his testimony, Hofmann added that Kehoe, as a member of executive management, would not have contacted him directly; rather, he would have been informed by McClain.

Hofmann's Takeout Rate Chart

Hofmann was very familiar with takeout rates because when he arrived at NYRA, he created a chart as a way of simplifying, into two pages, the complex Racing Law regarding the statutory takeout rates for on-track and off-track betting within New York State. He read the sections of the Racing Law and updated the chart periodically. The chart was available to the finance department in a shared computer file location that Hofmann referred to as the "revenue reconciliation folder," and was provided to NYRA's external auditors on several occasions.

This chart was cited in the Racing and Wagering Board's Interim Report as further evidence that "calls into question NYRA's claim that this was an inadvertent error." The chart at issue has a section entitled "Take-Out Range" and the range listed for exotic wagers is 15-25 percent. However, that range is listed under Racing Law section 229, the section of the law that dealt with NYRA takeout rates prior to the 2008 amendment to the law that codified the franchise agreement and placed the takeout rates under section 238 instead. The chart also includes a section entitled "current rates," and under the exotic wagers is listed "26.0%." The Interim Report asserts, "The spreadsheet indicates the current exotic rate of 26% while the takeout range is capped at 25%." Nevertheless, Hofmann's testimony regarding this part of the chart proved illuminating. Hofmann explained that he had not updated this chart since September 2008, when the one percent increase took effect. Because he had not heard otherwise, he assumed that the law had been extended and the September 15, 2008 rates were still in effect. The 15-25 percent rate for exotics remained on the chart as historical data – not evidence of the rates in effect post-September 15, 2010. Because the Racing and Wagering Board did not interview witnesses in producing its Interim Report, it was not privy to Hofmann's explanation.

Hofmann attested to speaking to Elizabeth Bracken prior to September 15, 2010, again regarding the takeout rates and the impending sunset dates. However, having been told nothing about an expiration and reversion, both assumed that the legislation had been extended. If Hofmann had been persistent in querying Kehoe, perhaps the sunset of the exotic takeout rate causing NYRA to be out of compliance with the law would have been discovered.

D. The Effect Of The 2008 Legislation On Simulcasting

When NYRA was forced by legislative mandate in 2008 to increase its takeout rate by one percent, NYRA renegotiated with most of its simulcast partners to split the one percent increase – NYRA received half the increase in the simulcast rate and the simulcast partner retained the other half. Accordingly, an examination of simulcasting and the simulcasting department is relevant to the instant investigation.

Simulcasting is the transmission of live races to various sites for the purpose of pari-mutuel betting. Simulcast bets are combined with on-track betting to form the pari-mutuel pool and, therefore, affect the odds and winnings. The host, where the live race is run, exports (sends) its signal, and the guest imports (receives) the signal. NYRA enters into simulcast contracts with licensed simulcast sites to both export and import signals to conduct pari-mutuel wagering. In 2011, simulcasting accounted for approximately 43 percent of NYRA's total revenue.[39]

Bracken was charged with managing the simulcasting department for NYRA. In its contracts with simulcasting partners, NYRA uses a standard industry simulcast contract and then appends exhibits to it to incorporate the NYRA-specific terms. Until recently, all simulcast contracts were approved by the Racing and Wagering Board. In January 2012, the Racing and

[39] In 2009 and 2010, simulcasting accounted for 60.2 percent and 59.1 percent of total revenue respectively. The significant decrease in simulcasting's percentage of total revenue in 2011 can be attributed to the closure of NYC OTB.

Wagering Board changed its policy and began to grant blanket approval to simulcast contracts as long as they were approved previously in the last calendar year; otherwise, the simulcast contract was to be submitted to the Racing and Wagering Board for a full review. According to Viscusi and consistent with NYRA's Simulcasting Policies and Procedures, until mid-2012, the law department reviewed yearly only the standard contract and appendices that were to be used; the law department did not review specific simulcasting contracts unless Bracken, a non-lawyer, thought that a legal question arose. However, following the revelation of NYRA's non-compliance with regard to the takeout rate for exotic wagers, that policy was amended and currently the law department must approve every simulcast contract before it is executed and sent to the Gaming Commission.

Simulcast rates differ from takeout rates. Simulcast rates represent percentages of handle and are negotiated with each simulcast site. According to Bracken, NYRA simulcast contracts include rates of anywhere between four and nine percent of handle, percentages that are far lower than the takeout rates for on-track betting. Simulcast sites, like OTBs, prefer higher takeout rates because the sites retain the takeout and pay these lower simulcast rates to the host tracks, in this instance, NYRA. Takeout rates, however, still affect simulcasting contracts because the simulcasting sites, with certain exceptions,[40] must charge the same takeout rate for NYRA races they are simulcasting as NYRA charges for on-track wagering. As such, part of every simulcast contract includes a list of the takeout rates then in effect. As noted above, when the Legislature imposed on NYRA the one percent increase in takeout rates, NYRA renegotiated with most of its simulcast sites to split the one percent increase.

Not surprisingly, given the renegotiation of most of the simulcasting contracts, Bracken attested to knowledge of the legislation that imposed the one percent increase on NYRA's

[40] Canada was permitted by the Racing and Wagering Board to change the takeout rates of New York State races.

takeout rates. She further acknowledged her awareness that the legislation was set to expire on September 15, 2010, two years after its effective date, although she did not memorialize the expiration date on a calendar. Bracken received a copy of Racing and Wagering Board's approval of the one percent increase in takeout rates, because, in order to complete the simulcast contracts, she must be aware of the takeout rates being charged. Furthermore, on occasion, simulcast sites with which NYRA contracts requested the Racing and Wagering Board approval letter of NYRA's takeout rates in order to provide it to their own regulators. In fact, on August 28, 2008, approximately two weeks before the one percent increase was set to take effect, Bracken emailed an excerpted section of the law that increased the takeout rates to a person who represents the Nevada casinos because, Bracken attested, the person needed to present the information to Nevada's regulator.

The email between Bracken and Nevada's regulator is depicted below:

From: Liz Bracken
Sent: Thursday, August 28, 2008 3:12 PM
To: [redacted]
Subject: FW: Takeout Increase

Excerpt from Chapter 115

(a) The franchised corporation authorized under this chapter to conduct pari-mutuel betting at a race meeting or races run thereat shall distribute all sums deposited in any pari-mutuel pool to the holders of winning tickets therein, provided such tickets be presented for payment before April first of the year following the year of their purchase, less an amount which shall be established and retained by such fran- chised corporation of between **[~~twelve~~]** **sixteen** to seventeen per centum of the total deposits in pools resulting from on-track regular bets, and **[~~fourteen~~]** **eighteen and one-half** to twenty-one per centum of the total deposits in pools resulting from on-track multiple bets and **[~~fifteen to twenty-five~~]** **twenty-six** per centum of the total deposits in pools resulting from on-track exotic bets and **[~~fifteen~~]** **sixteen** to thirty-six per centum of the total deposits in pools resulting from on-track super exotic bets**, and twenty-six to thirty-six per centum when such on-track super exotic betting pools are carried forward**, plus the breaks. The retention rate to be established is subject to the prior approval of the racing and wagering board.

As the email indicates, Bracken only emailed the relevant paragraph and the changes to the

takeout rates were underlined and in bold, as she had received them previously from Viscusi on August 11, 2008, explaining the parameters of the law.

The Inspector General confronted Bracken with this email:

Inspector General: Do you recall this email?

Bracken: I know we were again negotiating with them to get them to give us more money based on the new law.

Inspector General: And you provided an excerpt from the chapter?

Bracken: Yeah, because they have to – Nevada is another one that has to go back to their regulators.

Inspector General: Where did you get this from?

Bracken: I'm actually not sure.

Inspector General: Did you look at the statute and excerpt this?

Bracken: I believe this was emailed by our law department at that time.

Inspector General: To you?

Bracken: To probably a lot of people.

Inspector General: To everyone?

Bracken: Yeah, just to say, you know.

Inspector General: Did they email the full chapter of the law, the entire thing or just this excerpt?

Bracken: I don't remember.

Inspector General: Do you remember reviewing the law at that time?

Bracken: No.

Inspector General: The actual statute?

Bracken: No.

While the preponderance of the blame regarding the takeout overcharge that occurred at NYRA rests with the law department and specifically Kehoe, it is clear from Bracken's testimony that others at NYRA were provided the law and neglected to read and analyze its details. Undoubtedly, the negotiations over the simulcast contract with Nevada presented NYRA with an opportunity to have noted that the change in the law created a fixed takeout rate for exotic wagers, an opportunity it missed.

The Bracken/Widmer Emails

A September 1, 2010 email exchange between NYRA Revenue Accountant Christopher Widmer[41] and Bracken received much attention in the Racing and Wagering Board's Interim Report. The Inspector General has determined the following with regard to these emails.

For the period relevant to the instant investigation, Widmer was tasked with ensuring that NYRA was charging the correct simulcasting rates as delineated in the simulcast contracts and recording the revenue properly. In turn, Widmer routinely interacted with Bracken to confirm the simulcasting rates and to determine whether NYRA had entered into any new simulcast contracts. NYRA also uses an accounting settlement system called California Horse Racing Information Management System (CHRIMS).[42] CHRIMS requires the takeout rates and other data to be entered into the system before the calendar month is completed. Therefore, NYRA must communicate regularly with CHRIMS to assure accurate accounting.

The email exchange between Widmer and Bracken was presented in the Racing and Wagering Board Interim Report as an example of foreknowledge within NYRA that the takeout rates were about to expire. Widmer wrote to Bracken: "Do all rates remain the same until the

[41] In January 2011, Widmer was promoted to Manager of Net Settlements.

[42] CHRIMS is a not-for-profit, mutual benefits organization that provides technology solutions for the pari-mutuel gaming industry. CHRIMS specializes in accounting applications and pari-mutuel settlement outsourcing.

beginning of Belmont? When does the additional ½ % takeout end?" When queried by the Inspector General about this email, Widmer explained that each month, he would verify the rates for CHRIMS with Bracken. Therefore, because it was September 1, 2010, he was verifying the rates for CHRIMS for the month of September. As to his question about when the additional half percent takeout ends, Widmer reported that he had noticed language in some simulcast contracts regarding a half percent increase in simulcast rates for as long as the increased takeout rate was in effect. He explained further that he had "no idea" about the reason for this language in the contracts because he commenced employment at NYRA in 2009, after the enactment of the legislation that increased NYRA's takeout one percent. He just thought to ask about this issue because of the way the half percent increase was phrased. It was only in December 2011, after NYRA learned of its noncompliance as to the takeout rate for exotic wagers, that Widmer understood the basis for the half percent increase.

In response to Widmer's email inquiry of September 1, 2010, Bracken responded, "Current rates good until Belmont. Takeout legislation sunsets middle of September, but I have not heard that we intend to lower takeouts." Regarding her response, Bracken explained, as noted earlier, that she was aware that the takeout rates were scheduled to expire on September 15, 2010. However, if there were to be a change in takeout rates, either the law department or the Chief Operating Officer, at that time, Hal Handel, would have informed Bracken, and she had not heard anything from either. Bracken expounded, "I mean nobody really said anything. I was saying to [Widmer] from a, like I said, a public standpoint, maybe they want to make a change, maybe, not that we had to. You know, because I felt like I always thought if we had to do something like that, that our regulators would tell us that we had to."

Nevertheless, following this email inquiry from Widmer, Bracken testified that she inquired of Viscusi as to the status of the takeout rates. According to Bracken, Viscusi "kind of gave me the feeling that . . . the law might go on because of the problems at OTB, but basically we never brought it up again." Viscusi did not recall either a conversation with Bracken regarding the takeout rate or having researched the law in order to provide her a response, but he conceded that both were possible. This exchange between Viscusi and Bracken represents another missed opportunity to alert NYRA to the impending sunset of the takeout provision. On September 2, 2010, Widmer responded to Bracken's email asking her to keep him "posted on the takeout issue." However, Bracken reported that she never did so because she didn't have anything to tell him. Nor did Bracken inquire of Kehoe or Viscusi on September 15, 2010, the day she knew the takeout rates were due to sunset, if in fact they had. Unfortunately, Bracken relied on the law department to notify her of the reversion of the takeout rate. Bracken took no affirmative action to ensure NYRA was utilizing the statutory takeout rate then in effect.

E. NYRA Post September 15, 2010

On September 15, 2010, the takeout rates for NYRA that were enacted in 2008 expired and reverted to the previous ranges. As such, NYRA's takeout rate of 26 percent for its exotic wagers was out of compliance with the statutorily mandated range of 15-25 percent. Nevertheless, no one at NYRA – or the Racing and Wagering Board, as will be explored later in this report – discovered the error. In fact, the Inspector General did not uncover any emails, other than the Widmer/Bracken exchange discussed above, or other written communications among any NYRA executives discussing the impending sunset of the takeout rates any time before or on September 15, 2010, despite the proclamations that NYRA was in favor of lower takeout rates. In addition, no NYRA executives attested to any conversations about reducing

takeout rates at this time. Therefore, as is now known, for the next 15 months, NYRA continued to improperly charge a 26 percent takeout rate for exotic wagers, post it daily on its website, print it in its racing forms, report it to its totalisator company, utilize it in its simulcast contracts and, most importantly, take earnings away from the bettors that were rightfully theirs under the law.

In contrast to NYRA and the Racing and Wagering Board, the expiration of the takeout rate did not escape the notice of a bettor who, on September 28, 2010, contacted Hayward by email to inquire as to why takeout had not been lowered. This same bettor had contacted Hayward in 2008 to complain about the one percent increase in takeout at that time. The bettor wrote, "This takeout increase was supposed to sunset on September 15, 2010. I can't find anywhere that it has been removed and am quite sure that it hasn't since NYRA didn't promote it. We had emailed back and forth about this in 2008 and you told me that it would be removed, as scheduled, on the above date. Would you mind letting me know if it has or hasn't and if it hasn't, why?"

October 4, 2010 Kehoe Email

On October 4, 2010, at 12:20 p.m., Hayward forwarded the bettor's email to Kehoe with the comment, "Any thoughts on this?" Kehoe then drafted an email to Crowell at 12:33 p.m. inquiring as to whether the statute was extended. Kehoe wrote:

> Is there a way to check if the State extended the increased 1% in the minimum takeout threshold contained in section 238 in the budget bills?
>
> I don't think they did. The one percent increase was slated to sun set [sic] on September 15, 2010. If this was in fact allowed to sun set, NYRA would now have the option of taking the take out back down a percentage point.

> I'm not sure we would want to do that at this point in time, but I [sic] would be good to know if there was an extender or not. The section on Lexis[43] does not reflect that any extender was enacted, but Lexis is not always the word on these types of issues, as you know.

Kehoe did not recall this specific email but had a "loose recollection" of asking Crowell the status of the one percent increase. Notably, this email reflects Kehoe's fundamental misunderstanding of the statute resulting from his lax attention to it. Specifically, he wrote, "If this was in fact allowed to sun set [sic], NYRA would now have the *option* of taking the take out back down a percentage point." [Emphasis supplied] At this point, and apparently after having researched the statute in the Lexis database, Kehoe still failed to comprehend the impact of the fixed number rate for exotic bets after the statute had reverted to a range of 15-25 percent. Further evincing his negligence in not properly analyzing the law, Kehoe also indicated in his email that NYRA might not want to lower the takeout at this point. Kehoe explained to the Inspector General that he expressed this sentiment to Crowell because NYC OTB was facing closure and, had NYRA requested a reduction in takeout rates that had been raised in the first instance to assist NYC OTB, it would have been viewed as a hostile act when the state was attempting to salvage NYC OTB.

Prior to receiving a response from Crowell, Kehoe, on October 4, 2010, sent a lengthy email to Hayward detailing the parameters of the legislation:

[43] "Lexis" refers to the legal database LexisNexis.

From: Patrick Kehoe
Sent: Monday, October 4, 2010 2:03 PM
To: Patrick Kehoe ; Charles Hayward
Subject: RE: NYCOTB May Lower Revenue Sharing bloodhorse.com

OK, I've confirmed with Billy that this sunset was not extended, and the thresholds for takeout rates I've cited below are now in effect.

Best,

PK

-----Original Message-----
From: Patrick Kehoe
Sent: Monday, October 04, 2010 1:01 PM
To: Charles Hayward
Subject: RE: NYCOTB May Lower Revenue Sharing bloodhorse.com

Yes. Under §238 of the racing law, the take out rates for NYRA races are set out as thresholds (i.e., "between sixteen to seventeen per centum of the total deposits in pools resulting from on-track regular bets") and NYRA has the ability to adjust these rates once per fiscal quarter by so notifying the RWB.

As part of the state takeover of NYC OTB in 2008, the State increased the bottom threshold of the NYRA takeout rates by 1%. This increase was to sunset on September 15, 2010, and I believe it did (I'm having Crowell double check that this sunset was not extending in the state budget).

Assuming it did expire, the current thresholds within which NYRA could set its take out would be:

Regular	Between 12 to 17% (formerly 16 to 17%)
Multiple	Between 14 to 21% (formerly 18.5 to 21%)
Exotics	Between 15 to 25% (formerly 26%)
Super Exotics	Between 15 to 36% (formerly 16 to 36%; 26 to 36% on carryovers)

Assuming the State did not extend the sunset, I would suggest we consider the wisdom of adjusting our takeout while the NYC OTB matter is pending and likely to require legislative action sometime between now and January....if we let a sleeping dog lay we may get through the OTB legislation without this being addressed, and we'd be free to lower the take out after the dust with OTB has settled; if we lower them now it will likely make permanently increasing the lower threshold a legislative demand by NYC OTB (and the other OTBs).

There's no guarantee they won't catch on this, but since Crowell and I have been tasked with drafting the legislation needed for OTB to emerge from chapter 9, we have a better than even chance to keep this out of the mix.

I'll let you know when I get confirmation from Crowell that the sunset in this section was not extended in the budget.

Best,

PK

Initially, it must be noted that Kehoe testified that he did not recall this lengthy email, a fact problematic in itself. Nevertheless, the content of the email is equally problematic because it appears to correctly analyze the change in the law and the reversion takeout rates. Specifically, Kehoe wrote, "As part of the state takeover of NYC OTB in 2008, the State increased the bottom threshold of the NYRA takeout rates by 1%. This increase was to sunset on September 15, 2010, and I believe it did (I'm having Crowell check that this sunset was not extending [sic] in the state

budget)." He then listed the rates as statutorily mandated on that date, and included the pre-September 15, 2010 rates.

Regular	Between 12 to 17% (formerly 16 to 17%)
Multiple	Between 14 to 21% (formerly 18.5 to 21%)
Exotics	**Between 15 to 25% (formerly 26%)**
Super Exotics	Between 15 to 36 % (formerly 16 to 36%; 26 to 36% on carryovers)

[Emphasis supplied].

Given that this chart delineates the exact information necessary for NYRA to have properly assessed its noncompliance, the Inspector General inquired of Kehoe as to the origin of this information:

Inspector General: Below that you said, assuming it did expire the current threshold within in [sic] NYRA could set, the takeout would be, and you go through the various regular multiple exotics and super exotics wages, correct?

Kehoe: Yes.

Inspector General: And you point out the different percentages?

Kehoe: Correct.

Inspector General: Where did you get those percentages from?

Kehoe: That I don't know. I wish I had that recollection. It's not information I would have had with me. This is not a chart I would have made. So I must have gotten it from somebody. I don't know from whom.

Inspector General: Would it have been somebody in your legal department?

Kehoe: Again, I can only assume. I don't know who else I would have asked. Just judging by the formatting here, it would appear to be something I would have cut and pasted, but I do not have a specific recollection of where I got that chart from, but it's certainly – it's not – it's really not the level that I would have gotten into. So I can't speculate further as to where it came from.

Inspector General: Just drawing your attention to the exotics it says, between 15 to 25 percent and you have in parens formerly 26 percent, what does that mean?

Kehoe: You know, I am just trying to make sense of what it is here. Formerly, I assume relates to assuming it did expire. So had it expired, the rate under the unexpired section would have been 26 percent. Having expired, it would have gone back to whatever it was in 2008.

When pressed about the chart within the greater context of the entire email, Kehoe asserted, "I don't believe that I focused on that chart. I think had I focused on that chart, I would like to have thought I would have noticed that there is actually a problem there." To be sure, this chart and Kehoe's lack of focus on it represents yet another missed opportunity to uncover NYRA's noncompliance with the exotic wager takeout rate. Given Kehoe's assertion that it appears to be something that he cut and pasted into his email, the Inspector General asked Williams & Connolly LLP, attorneys for the NYRA Board and the firm responsible for NYRA's production of documents to this office, to conduct a search of NYRA's database for this chart. Following a search by NYRA's Information Technology Department across NYRA servers, Williams & Connolly reported that no version of the chart was found.

In his October 4, 2010 email, Kehoe continued his explanation to Hayward:

> Assuming the State did not extend the sunset, I would suggest we consider the wisdom of adjusting our takeout while the NYC OTB matter is pending and likely to require legislative action sometime between now and January . . . if we let a sleeping dog lay we may get through the OTB legislation without this being addressed, and we'd be free to lower the take out after the dust with OTB has settled; if we lower them now it will likely make permanently increasing the lower threshold a legislative demand by NYC OTB (and the other OTBs). [Ellipses in original]
>
> There's no guarantee they won't catch on this, but since Crowell and I have been tasked with drafting the legislation needed for OTB to emerge from Chapter 9, we have a better than even chance to keep this out of the mix.

When asked what he meant by these statements, Kehoe reiterated that he did not recall the email but assumed that because NYRA was negotiating at that time with the state as one of the creditors of NYC OTB and the parties were attempting to reach a resolution, applying to lower NYRA's takeout rates might have caused the higher rates to be included in this new potential legislation – a result that NYRA was trying to avoid. Kehoe expounded in his testimony before the Inspector General:

> My analysis about sleeping dogs lie had to do with politics. That if we raise this takeout issue now, we're going to risk the takeout being permanently set higher. Not that we are out of compliance and we could hide the ball. That certainly was not my analysis at all. That's what I believed my analysis was that –you know, if it has sunset, we should bide our time on the takeout issue until we see what resolution there is at New York City OTB, at which time then we can make a decision. Again, assuming we have the option and not the obligation to change the takeout.

Crowell responded to Kehoe's email at 2:01 p.m. by sending a copy of the legislation, without comment, that he had retrieved from the Legislative Retrieval System (LRS) – an up-to-date database of legislation. The heading of the legislation included the notation, "As of 09/29/2010 01:09 PM." In his testimony before the Inspector General, Crowell stated that he did not recall Kehoe's October 4, 2010 email, but he acknowledged that the legislation was sent to Kehoe from his LRS email account. When questioned as to whether sending the legislation absent explanation to Kehoe was sufficiently responsive to Kehoe's inquiry as to "whether there [was] a way to check if the state extended the increased one percent in the minimum takeout threshold contained in Section 238," Crowell declared:

> Yeah, there is a way, provide him with a copy of the statute. He's quite capable of reading the statute himself to make sure that – I had no idea what their takeout was or wasn't at that particular point in time. So I provided him with it. At the end, he made a reference to the fact that Lexis does not always reflect, you know. So LRS is generally regarded as the most up-to-date repository for statutory information. So by sending him that, you know, I mean it was a one-off question, asking [me] for a statute. If he had wanted more information or wanted, what do

> you think, I'm sure he would have called me back. I don't have any recollection of any call or any discussion. I just provided him with the information in the statute and that's it.

When pressed as to whether any follow-up telephone conversation took place, Crowell felt confident that if a call had occurred, he would have remembered it. Kehoe similarly could not recall a telephone conversation with Crowell. Kehoe's testimony about his relationship with and his expectation of Crowell supports Crowell's response. Kehoe related that while he would have welcomed a "full analysis of each section . . . and the ramifications one way or the other," he only expected Crowell to inform him as to whether the statute had sunset.

At 2:03 p.m., two minutes after receiving the legislation from Crowell, Kehoe sent an email to Hayward stating: "OK. I've confirmed with Billy that this sunset was not extended, and the thresholds for takeout rates I've cited below [in the chart discussed above] are now in effect." Hayward testified that he did not recall receiving this email or noting its contents. It also does not appear that Hayward responded to Kehoe or the bettor whose inquiry generated the question in the first instance.

At 2:07 p.m., Kehoe received yet another piece of legislation from Crowell's LRS account: Senate bill 8285, Assembly bill 11515, which was signed into law on June 21, 2010, the end of the legislative session. Unlike the previous email from Crowell that provided section 238 in which the relevant takeout section is included, this email provided an omnibus bill – a proposed law that covers a number of unrelated topics. This omnibus bill is representative of the type of end-of-session legislation in which extenders of sunset dates would be included. In fact, this legislation extended, among other sections of law, certain sunset dates of section 238(1)(a); specifically, the sunset dates of the pari-mutuel taxes for certain wagers. The extension of the legislation is reflected by the crossed out word "ten" of the year two thousand and ten and the

replacement with the word "eleven." Kehoe testified that he did not recall receiving this email either; upon review of pertinent Crowell emails prior to testifying before the Inspector General, he believed that reading this legislation "quickly" led him to believe that the sunset provisions of the takeout rates had been extended. Kehoe testified thusly because, as will be discussed later, on October 24, 2010, Kehoe responded to another inquiry by Hayward regarding the expiration of the takeout rates by attaching this 2:07 p.m. email from Crowell and incorrectly informing Hayward that the takeout rates had been extended. Notwithstanding Kehoe's belief as to what he thought at the time, the Inspector General observed that there does not appear to be a subsequent email to Hayward on October 4, 2010, rectifying Kehoe's purported error in reading the June 2010 legislation. Kehoe speculated that perhaps they spoke by telephone, although neither he nor Hayward could recall a conversation.

Given that, based on this second October 4, 2010, 2:07 p.m. Crowell email, it does not appear that Kehoe modified his earlier statement to Hayward regarding the takeout legislation, the Inspector General questions whether Kehoe even read the June 2010 legislation at that time. Moreover, had he read the Crowell emails thoroughly, he would have realized that the first Crowell email included an up-to-date version of section 238 that included the extended sunset dates for the pari-mutuel taxes that were extended by the June 21, 2010 legislation – the second Crowell email. Although seemingly unnecessary given Kehoe's status as longtime General Counsel to NYRA, if Kehoe had had any question as to his interpretation of the then current status of the law regarding takeout, he could have consulted with Crowell and requested a legal opinion. He did not do so.

Crowell testified that he merely sent Kehoe the legislation and did not read it. Crowell explained that he reviewed his calendar prior to testifying before the Inspector General and

realized that he had had an event in New York City the evening of October 4, 2010. As such, he believed that he sent the requested legislation but did not read it because, at approximately 2:00 p.m. when he was sending these emails, he would have been preparing to leave his office for the New York City event. Crowell admitted, however, that he had no independent recollection of these events; rather, he reconstructed them using his calendar. If Crowell's reconstruction of the facts is correct, then his lack of curiosity and follow-up with Kehoe is disconcerting. As NYRA's legislative counsel, Crowell, at some point, should have reviewed the statute relating to NYRA, his longtime client, and inquired if any legislative or remedial action was required.

October 24, 2010 Emails Discussing the Takeout Legislation

These Crowell emails and Kehoe's misinterpretation of them became relevant again on October 24, 2010, a mere three weeks after Kehoe had received them and sent the October 4, 2010 email to Hayward stating that the takeout rates had not been extended. On Sunday, October 24, 2010, the same bettor who had contacted Hayward in late September 2010 to inquire whether the takeout rates had sunset, sent an email to a person involved in horse racing and takeout issues and copied Hayward. The bettor complained that Hayward, uncharacteristically, had not responded to his last email regarding reducing takeout after the September 15, 2010 sunset date. He noted that the media had not reported anything about the expiration of the rates. Hayward was on vacation in Europe at the time but forwarded the bettor's email to Kehoe at 12:43 p.m., and added, "This guy has written a number of times in [sic] this topic. Did the provision sunset or what is the status?" When confronted with this October 24, 2010 email, Hayward stated that he did not recall at that time the October 4, 2010 email from Kehoe that stated that the rates had not been extended.

Notably, this request presented yet another squandered opportunity for Kehoe to review section 238 to properly assess the state of the law and NYRA's compliance with it. At 1:38 p.m., Kehoe sent an email to Hayward from his Blackberry, an indication that he offered this information from memory, stating, "The provision was extended by the legislature as part of the budget. NYRA's take out rates are as low as is allowed by statute." Hayward recalled receiving this email. As with the other emails from this period relevant to takeout, Kehoe had no memory of sending this response to Hayward; however, he assumed, based on the documentary evidence before him, that he responded to Hayward in this way because of the aforementioned October 4, 2010, 2:07 p.m. Crowell email that forwarded the omnibus legislation from which Kehoe testified that he improperly concluded that the takeout rate sunset date had been extended.

At 2:16 p.m., Kehoe again responded to Hayward's email. This time he forwarded to Hayward the October 4, 2010, 2:07 p.m. email from Crowell of the June 2010 omnibus bill discussed earlier that, among other things, extended the sunset dates of certain pari-mutuel taxes, and not the takeout rates. Attached to the forwarded email Kehoe wrote, in pertinent part: "The link attached hereto is the section of the budget that extended all of the Racing Law sunsets for an additional year. These extenders are automatically generated and placed in the budget bills without our input."

On October 25, 2010, Hayward responded to the bettor: "According to Patrick Kehoe, the takeout provisions were extended when the budget was passed earlier this year. Our takeout rates are as low as they can be by State law. Reducing takeout rates will be a priority for 2011 but as you know it is always a challenge do [sic] to the OTBs." Hayward noted in his testimony to the Inspector General that the language of his response closely mirrors the language sent to him by Kehoe. Hayward added, "I believe when I ask a legal question of my general counsel

and he gives me an answer, I believe it." Indeed, Kehoe summed up the problem in this way to the Inspector General: "[U]nfortunately, I gave bad advice."

NYRA Considers a Reduction in Takeout in June 2011

Despite this bad advice that the takeout rates had been extended to September 15, 2011, on June 21, 2011, Hayward asked Kehoe about implementing a one percent reduction in all takeout rates and Kehoe initiated the process to institute the change. Kehoe related that Hayward contacted him by telephone on June 21, 2011, and asked him about reducing the takeout rates because the racing season at Saratoga, NYRA's most profitable track, was approaching. Kehoe explained:

> I do know the importance at this point in time would have been and was we were coming up on Saratoga, if you're going to make reduction of the takeout, that's the time to do it. That's your highest volume meet. If you're going to rely on volume to offset a decrease in takeout, you want to make it going into Saratoga. You don't want to make it in February.

Kehoe explained that he remembered receiving the call from Hayward because he was leaving for a family vacation. He stated that he informed Hayward that he was leaving but that he would instruct Viscusi to prepare a letter request for the Racing and Wagering Board. Kehoe reported that he reminded Hayward that any request to change takeout rates had to be made by the next fiscal quarter, which would have been July 1, 2011. The Inspector General questioned Kehoe about the inherent conflict between his misunderstanding that the takeout rates had been extended as reflected in his October 24, 2010 email to Hayward and his instructions to Viscusi to prepare a request to lower the takeout rates on June 21, 2011. Kehoe could not recall what had occurred between those dates to change his mind that the law had expired and that NYRA now had the option to change its takeout rates – a misunderstanding of the law as well – but he

conceded that, given his actions in June 2011, he must have done so. In fact, although Viscusi prepared a draft letter, no request to lower the takeout rates was made.

Hayward asserted to the Inspector General that Kehoe had misunderstood his request on June 21, 2011. Hayward stated that, because the Aqueduct Racino was supposed to be operational in October 2011 and NYRA would receive statutorily mandated percentages of the money generated by the racino, the timing was right to begin planning for a reduction in takeout for October. Hayward asserted:

> Viscusi did a draft of what a request of the state waging board might look like. When I got that, I said, guys, we've got to slow down because first of all, we're not looking to do this by July 1st because that's less than ten days away. But I'd like to target, you know, October 1st as a way to do it.

Notwithstanding this statement, documentary evidence does not support Hayward's explanation to the Inspector General.[44] Specifically, as Kehoe explained, following his telephone conversation with Hayward on June 21, 2011, he drafted an email to Viscusi instructing him on the actions to be taken. Kehoe wrote, in relevant part: "We may wish to make an application to the RWB for a takeout decrease. We should shoot to have it take effect at the start of July to correspond with the next fiscal quarter." Viscusi responded, "Okay," and Kehoe forwarded the email stream to Hayward. An hour later, Hayward wrote, "We would like to roll back the 1% across the board takeout increase that was forced on us at the time we got the new franchise in October 2008." Notably, Hayward did not correct Kehoe's statement to "shoot to have it take effect at the start of July." Furthermore, in an August 1, 2011 email to Steven Crist, the publisher and columnist of the *Daily Racing Form* and a friend of Hayward, that discussed the issue of reducing takeout, Hayward stated, "We originally had thought that we would

[44] When questioned, Hayward could not recall his state of mind in June 2011 as to the status of the law as it relates to NYRA's takeout rates.

announce this [reduction in takeout] for Saratoga [which commences in mid-July] but political forces intervened."

Regardless of whether political forces intervened, the request was not made to the Racing and Wagering Board. On June 30, 2011, at 7:29 p.m., Viscusi, having drafted a letter for a request of the Racing and Wagering Board, realized that June 30, 2011, was the last day to file the request for the next fiscal quarter. Accordingly, he inquired of Hayward and Kehoe as to whether they wanted to submit the request to lower the takeout rate. On July 1, 2011, too late to file the request, Hayward wrote to Kehoe but included Viscusi in the conversation: "I have discussed this with [NYRA Chair] Steve [Duncker] who wholeheartedly agrees. Do we need Finance committee. As you know this would simply be reinstating the takeout structure that existed before the legislative mandate when we got the franchise in 2008. I think that there would be some issues for [Vice President of Simulcasting] Liz [Bracken] and the simo contracts. Let's discuss live today." Kehoe responded, "I think we should definitely have a finance committee call to approve this." When questioned as to whether this proposed decrease in takeout was presented to the finance committee, Kehoe stated that he was unaware of any finance committee call; Hayward stated that NYRA "never promulgated the proposal." Kehoe speculated that Hayward realized that the time to file the request had passed. The next fiscal quarter by which to file the request would have been October; however, as Kehoe explained, that "would not generally be the time you would want to do that. So it would have been laid over for another year." In fact, no request was made to the Racing and Wagering Board in October to lower takeout rates. The only time that NYRA requested a reduction in takeout rates was after the mid-December 2011 discovery of its noncompliance.

The Crist/Hayward Emails

On August 1, 2011, as noted above, Hayward received an email from Steven Crist, his friend and the publisher and columnist of the *Daily Racing Form*, asking for a comment regarding a question posed by one of his readers. This email received much attention in the Racing and Wagering Board April 29, 2012 Interim Report. The Interim Report concluded:

> In August 2011 (almost a year after the rates had expired) the Daily Racing Form (DRF) publisher and columnist Steve Crist passed along an email from a DRF reader indicating the rates had expired and were outside the parameters of the Racing Law. Mr. Hayward emailed Mr. Crist on August 1 2011 confirming that the reader was correct and requested that Mr. Crist keep the information confidential. Mr. Crist agreed. [Parentheticals in original].

As will be discussed later in this report, the Racing and Wagering Board presented its Interim Report without having interviewed any witnesses; it reached conclusions based only on the texts of emails and other documents. As will be demonstrated below, the Inspector General conducted a lengthy sworn interview of Hayward, which provides greater insight into this email exchange.

The August 1, 2011 email exchange between Crist and Hayward was as follows. Crist forwarded a question from one of his readers to Hayward for response. The *Daily Racing Form* reader wrote:

> The 2008 NYCOTB takeout increase legislation included a sunset provision that went into effect on September 15, 2010. (Article 2 Section 238 of the Racing, Pari-Mutuel and Breeding Law) The takeout limits allowed by law are now 12-17% for w/p/s, 14-21% for exacta/double wager 15-25% for tris/super and P3/4 and 15-36% for P6 with no separate rates for carryover and non-carryover pools. **(Please note that the tri/super/P3/P4 takeout is currently at 26% which is currently outside the parameters of the law.)** [Emphasis supplied]
>
> NYRA may be waiting for the VLT money before they lower any takeouts, but if NYRA wanted to lower takeout all they have to do is make a request to the NYSRWB, which would most likely to [sic] approve the request.

Crist asked Hayward, "Is this true?" Hayward responded:

> This gentleman is correct. Off the record, we have been working on this for some time. We originally had thought that we would announce this for Saratoga but political forces intervened. Since we are showing substantial losses in 2010 and 2011 and we have been smacked around by Cuomo (and he could check the SRWB from approving), we decided to wait. Also, the regional OTBs who collectively lost money in 2010 will scream like stuck pigs and that would provoke Skelos who is very tight with the guys who run Nassau OTB to introduce anti-NYRA legislation for the benefit of the OTBs. Finally, we are quietly working on a plan to open 10 or so restaurant/bars in the city and we did not want the politicos to block this effort.
>
> We have had some internal debates on how much to lower each pool and how we would present this to our simo customers, the consumers and the politicos. I would appreciate it if you could keep these details confidential. I would also welcome a further discussion on this topic with you before the meet is over.

Crist promised to keep the information confidential and asked to have an "off the record" conversation about "possible reduction schemes." Hayward replied that they should have dinner soon.

In his testimony, Hayward asserted the following about this seemingly revealing email. Hayward explained that when he wrote, "This gentleman is correct," he had not read the first paragraph of the email carefully – the part that clearly notes that NYRA's current exotic wager takeout rate was "outside the parameters of the law" – and was referring to the part of the statement that NYRA was waiting for the VLT money and only needed to apply to the Racing and Wagering Board for a reduction in takeout rates. Hayward testified:

Hayward: What my comments are directed to is that we could have the ability to go in the state racing and wagering board and make a request, that these are the issues that we face. I'm not responding to paragraph 1. I'm responding to his paragraph 2. "NYRA may be waiting for the VLT money before they lower any take-outs." But if NYRA wanted to lower the take-out rate, all they would have to do is request the state racing and wagering board.

Inspector General: So what you were saying to us is, you were ignoring paragraph 1?

Hayward: Correct.

Inspector General: The next paragraph of your response, you said –

Hayward: Let's not say I ignored it. I didn't understand it. I didn't understand the implications of what those ranges were.

Hayward pointed to his explanation in the email as support for this assertion. Specifically, Hayward noted: "And in my response, I say we've been smacked around by Cuomo, and he could check the Racing and Wagering Board from approving. Now if I knew we were outside the statutory law. Would I suggest that Cuomo might not approve that by the Racing and Wagering Board? I don't think I would."

Hayward then offered a brief financial history that he deemed relevant to understanding this email response. Hayward explained that in November 2009, NYRA was at risk of running out of money. He went to Division of the Budget Director Robert Megna, who was also chair of the Franchise Oversight Board, and invoked the Franchise Agreement which, according to Hayward, assured NYRA financial assistance from the state if the Aqueduct Racino was not operational by April 2009. Megna, according to Hayward, proclaimed that the state also was at risk of running out of money; therefore, instead of giving NYRA money, Megna loaned NYRA $8 million and promised that the VLT operator chosen to construct and run the Aqueduct Racino would assume the loan and loan NYRA up to $25 million. By the date of this email, Genting, the chosen Aqueduct VLT operator, had loaned NYRA the full $25 million. Hayward further expounded:

> [T]here is no way in the world that we felt that we could go in two and a half months after we've just gotten bailed out with a 25 million dollar loan and say to the state politically that we want to take our reduction because the politicians, frankly, view a take-out like cigarette tax or a liquor tax. It's like a vice tax. So they don't believe take-out reduction improves the business. They just don't, and the OTBs certainly tell them that it doesn't. . . . So that's why when we talk about the political opponents and why we don't think that we can do it – this is in 2011 but right on the heels of all of the activity of the prior year.

As to the comment about fearing provocation of the Nassau County OTB and its senate representative, Hayward opined that even though NYC OTB had closed, the OTBs, who consistently lobbied for higher takeout rates, had significant influence with the Republican Party, and especially the Nassau County OTB.

As to the statement, "we are quietly working on a plan to open 10 or so restaurant/bars in the city and we did not want the politicos to block this effort," Hayward explained that, in an effort to recoup the clientele and business lost from the closure of NYC OTB which represented 15 percent of NYRA's revenue, NYRA was attempting to open OTB betting areas in New York City restaurants. Hayward explained that the unions wanted NYRA to employ pari-mutuel clerks in those restaurants who were union members, which was not NYRA's intention. The unions, therefore, were fighting NYRA's request to open these restaurants and any requests to lower takeout rates could negatively affect this venture. Finally, with regard to Hayward's request to Crist to "keep these details confidential," Hayward explained that there was nothing sinister in his request: it is simply the language he employed when speaking to a news journalist to indicate that the contents of the conversation should not be printed.

In preparation for questioning surrounding this email exchange, the Inspector General reviewed all the documents in the possession of the Racing and Wagering Board in formulating its report and conclusions and additional documents and testimony obtained as part of the Inspector General's investigation. It must be noted that the Inspector General's interview of Hayward regarding this one email comprises 15 pages of testimony – information that the Racing and Wagering Board lacked in formulating its conclusions.

The Inspector General has determined that Hayward provided a less than satisfying explanation for this email exchange, and was, at best, careless in his reading of this email that

presented yet another opportunity for NYRA to catch its noncompliance with the statutory takeout rate for exotic wagers. More significantly, Hayward was derelict in his duties as President and CEO of NYRA in failing to catch NYRA's noncompliance with the statutory takeout rate for exotic wagers culminating in this email, of which he ignored the most salient issue.

F. The Discovery of NYRA's Noncompliance

On or about December 6, 2011, the Office of the State Comptroller, during an audit of the New York State Thoroughbred Breeding and Development Fund (Fund), contacted then Racing and Wagering Board Counsel Feuerstein to inquire as to the proper percentage required to be paid to the Fund. As a corollary to that inquiry, the State Comptroller also questioned whether NYRA was retaining the correct takeout rates under the law. The Racing and Wagering Board reviewed the matter and determined that NYRA's imposed exotic wager takeout rate was in excess of statutory limits. Specifically, NYRA was retaining 26 percent for exotic wagers when the law, since September 15, 2010, only permitted a takeout rate for exotic wagers within the range of 15-25 percent. On December 8, 2011, the Racing and Wagering Board informed NYRA of its analysis of the law governing NYRA's takeout rates. Although initially NYRA reported that it believed it was in compliance with current takeout provisions, on December 15, 2011, NYRA concurred with the Racing and Wagering Board's determination that in fact, the 26 percent takeout rate it was retaining for exotic wagers was outside the parameters of the law.

G. NYRA's Response to the Discovery of Noncompliance

In the next few days, NYRA formulated a plan to lower the takeout rate for exotic wagers and to commence the process for identifying and providing restitution to the affected bettors. Initially, on December 21, 2011, NYRA submitted a written request to the Racing and Wagering

Board to lower its exotic bet takeout to 24 percent[45] – a percentage point lower than legally required. NYRA then attempted to identify those bettors who were wrongfully charged an additional one percent takeout on exotic wagers for the 15-month period of September 16, 2010, until December 2011. NYRA determined that it had incorrectly withheld $1,140,622 for on-track wagers, and $6,221,100 had been erroneously retained by racetracks and off-track betting sites. NYRA was able to identify and repay approximately $600,000 to on-track bettors who had wagered through the NYRA Rewards program or who had received a tax document memorializing the payout.

When the takeout noncompliance was initially discovered, NYRA Board members did not suspend – with or without pay – or terminate either Hayward or Kehoe, even though, according to then NYRA Chairman Duncker, they both immediately admitted, "We just missed it. We made a mistake." NYRA Board Member Charles Wait said as much in a December 29, 2011 article in *The Saratogian* entitled "NYRA Board Member Charles Wait Says Firing Not Warranted." The following statements are excerpted from the article: "These things happen from time to time in business. It clearly was unintentional. We're going to refund all the people we can. There's just not much we can do about it at this point"; NYRA President and CEO Charles Hayward took full responsibility for the incident in a story published in the *Daily Racing Form*; "There's a lot of people inside NYRA and the state that had the opportunity to review that, and the bottom line is we missed it."

It is clear from these statements and the NYRA Board's inaction that no one even considered suspension at this point, notwithstanding that Hayward and Kehoe both admitted in

[45] NYRA also lowered the takeout rates on super exotic wagers, which carry over from a previous racing day, from 26 to 24 percent even though the 26 percent rate for super exotic bets was within the statutory range for that bet type at all times.

December 2011 to the same subpar performance that was provided as the bases for their suspension and eventual termination in May 2012.

NYRA's Business Integrity Counsel

In order to accurately assess this major breakdown in NYRA's statutory compliance, the Inspector General sought to speak to NYRA's business integrity counsel, Jonathan S. Sack, Esq. of Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer, charged with helping to ensure integrity at NYRA. NYRA formally retained Sack as business integrity counsel in June 2011, approximately six months prior to the discovery of NYRA's 15-month noncompliance.[46] Relevant to the instant investigation, when NYRA's noncompliance with the statutorily mandated takeout rate for exotic wagers was uncovered in December 2011, the NYRA Board Special Oversight Committee headed by then Vice Chair Heffernan tasked Sack with conducting an internal investigation. Sack and his associates engaged in such an investigation and assisted NYRA in its document production to the Racing and Wagering Board. As such, the Inspector General requested production of Sack's findings.

In response to this request, NYRA's then Board asserted attorney-client privilege as to the business integrity counsel.[47] However, in June 2012, legislation was enacted that created the NYRA Reorganization Board, discussed later in this report. By the end of 2012, Governor Cuomo had appointed his eight members and David Skorton was named Chairman of the Board. With the formation of the Reorganization Board, the Inspector General again broached the subject of waiver of privilege with regard to the business integrity counsel. In October 2013, the

[46] Prior to Sack, NYRA retained Getnick & Getnick, the former NYRA court-appointed monitor, as its business integrity counsel.
[47] NYRA's Board also asserted attorney-client privilege as to the former business integrity counsel, Getnick & Getnick.

Reorganization Board agreed to waive privilege as to the business integrity counsel's internal investigation into the takeout overcharge, and Sack promptly provided documents to the Inspector General.

During the first two weeks of January 2012, Sack and an associate interviewed numerous NYRA employees and non-employees as part of the internal investigation, and on January 12, 2012, Sack presented his preliminary findings to the Special Oversight Committee of the NYRA Board. Sack informed the members that "primary responsibility for this error belongs to the Law Department and NYRA's in-house lawyers" – specifically Kehoe and Viscusi. He noted that "NYRA had no formal tickler system for monitoring changes to the Racing Law," and, as a result, the expiration of the fixed takeout rate for exotic wagers went unmonitored. Sack also recommended a formal compliance program that would confirm statutory rates on a quarterly basis. With regard to Hayward, Sack reported to the committee that Hayward had informed him of an early 2011 email from Crist discussing takeout rates, and that this email, and other evidence, may exist indicating that "NYRA may have been notified about the sunset provision before and/or after it took effect." Sack related that he had not yet seen the Crist email or other emails. Sack noted that while he still awaited some document production and anticipated interviewing more witnesses, he did not believe that either would change his conclusions, but he could not rule out the possibility.

On February 14, 2012, Sack accompanied NYRA executives to the Franchise Oversight Board meeting to answer any questions. During that meeting, Sack offered the following statement:

> At the request of the Special Oversight Committee of the Board of NYRA, I interview[ed] quite a few people and have reviewed documents. There may be some additional documents to review and people to talk to but I have done quite a

> bit of work and I saw no indication of intentional wrongdoing. Which I think is very, at least clearly indicated by the fact that NYRA correctly publish[ed] its takeout rates. They were incorrectly, in the case of the exotic wagers, they were one percent too high, but it provided correct information, and if anything indicated that they were one percent above what the law was. So, while that is not definitive, it's certainly highly suggestive evidence that no one was trying to deceive anyone and no one was intentionally trying to impose a higher takeout rate. And that's what my review has shown too.
>
> * * *
>
> What I would just add from my review is that it does not appear that anyone saw the mistake and perpetuated it. So what it indicates is quite a number of people who were in a position to see the mistake didn't identify it.

Then, on February 29, 2012, Duncker presented Sack's findings to the entire Board of Directors using an outline prepared by Sack and his associate. Duncker reported that the integrity counsel has preliminarily concluded that "no NYRA employee (1) purposely caused NYRA to fall out of compliance or (2) knew of NYRA's non-compliance and failed to say something about the error." The outline notes that NYRA employees should have caught the error, and that integrity counsel came across some "problematic documents . . . that may lead to criticism from the Racing and Wagering Board." Sack stated in the outline, however, that the documents did not alter his conclusion.

In mid-March 2012, during NYRA's document review and production to the Racing and Wagering Board, Sack obtained the August 1, 2011 Crist/Hayward emails. On March 23, 2012, Sack then re-interviewed Kehoe and Hayward regarding this exchange and other emails. Kehoe said he did not recall the August 2011 Crist/Hayward emails, nor did he recall Hayward inquiring of him regarding the Crist email. Sack also questioned Hayward regarding these emails. Hayward's statement to Sack is consistent with his testimony to the Inspector General. Sack also inquired of Kehoe regarding the October 4, 2010 email from a bettor to Hayward. Kehoe had no recollection of that email, but he believed it prompted an email 15 minutes later to

Crowell asking whether the law had sunset. Hayward told Sack that he only vaguely recalled the October 4, 2010 email from the bettor.

On April 9, 2012, Sack sent these emails to Heffernan, stating that he brought these documents to his attention "because they directly relate to some matters we reported to the [Special Oversight Committee] in January, and because they will be embarrassing if they become public in the future." Sack noted that these emails did not change his conclusions, "but they highlight the extent to which senior management missed opportunities to see and correct the mistake." He added that the Hayward emails were known to the Racing and Wagering Board; the Kehoe/Crowell exchange was withheld on attorney-client privilege grounds. Although in possession of these emails and Sacks comments well before the release of the Racing and Wagering Board Interim Report, the NYRA Board did not suspend Hayward and Kehoe at this time.

On April 26, 2012, the Racing and Wagering Board released its Interim Report. On April 30, 2012, Sack emailed to Heffernan the October 4, 2010 emails and October 24, 2010 email discussed earlier in this report. Sack stated that he intended to review them with Kehoe and Hayward. The NYRA Board, however, suspended both Kehoe and Hayward on that date. On May 1, 2012, Sack sent to Duncker and Heffernan a chronology "summarizing key emails among NYRA management regarding the takeout issue." The chronology included emails cited in the Racing and Wagering Board Interim Report and others; the emails were attached to the chronology as exhibits. On May 4, 2012, the NYRA Board terminated Hayward and Kehoe.

H. The Racing and Wagering Board's Interim Report

On December 21, 2011, at the request of the New York State Franchise Oversight Board, the Racing and Wagering Board commenced an investigation into the circumstances surrounding NYRA's failure to comply with the law for 15 months as to the takeout rate for exotic wagers. Then Franchise Oversight Board Chair Robert Megna directed the Racing and Wagering Board to determine who was responsible for the takeout overcharge and why audit standards and integrity controls failed to uncover the noncompliance. Accordingly, the Racing and Wagering Board issued numerous document requests to NYRA. Heffernan informed the Inspector General that Sack and his associates were working with NYRA to effectuate the document production process to the Racing and Wagering Board.

On April 26, 2012, the Racing and Wagering Board Audits and Investigations Unit issued a report to the Franchise Oversight Board entitled, "Interim Report into the Matter of Incorrect Takeout Rates at the New York Racing Association, Inc." The Interim Report concluded, among other things: "The documentation received from NYRA indicates a knowledge of the violation [by executive management and] failure to report that information in a timely fashion and take corrective action." The Racing and Wagering Board also noted that in contrast to the conclusions delineated in its Interim Report, NYRA had reported to the Racing and Wagering Board that any noncompliance with the takeout law was an "inadvertent error" and a "mistake."

I. The Termination of Hayward and Kehoe

On April 29, 2012, Megna asked the Inspector General to initiate an investigation based on the information contained in the Racing and Wagering Interim Report, and the Inspector

General commenced an investigation of NYRA's knowledge of its noncompliance with the statutorily mandated takeout rate.[48]

On April 30, 2012, Kehoe and Hayward were suspended by the NYRA Board, and on May 4, 2012, their employment with NYRA was terminated. When the NYRA Board officially terminated Hayward and Kehoe, Duncker stated that NYRA decided "that these executives failed to perform their duties at a level required by the board."[49]

The assessment by Duncker, and apparently the remaining Board members, regarding the substandard performance by Hayward and Kehoe was equally applicable when the noncompliance was first discovered in December 2011. Nevertheless, it does not appear that the NYRA Board considered suspension or termination at that time. In addition, Sack apprised Heffernan of many of the emails cited in the Racing and Wagering Report as early as April 9, 2012, yet the Board did not act at that time. Despite this foreknowledge, Hayward and Kehoe were not terminated until the Racing and Wagering Board's Interim Report was issued.

J. The Racing and Wagering Board Failed to Recognize the Takeout Error

As noted earlier, the Racing and Wagering Board maintained "jurisdiction over all horse racing activities and all pari-mutuel betting activities, both on-track and off-track, in the state and over the corporations, associations, and persons engaged therein." As such, the Racing and Wagering Board had jurisdiction over NYRA. Although the 2008 legislation that codified NYRA's franchise agreement with the state and created the Franchise Oversight Board transferred to the new board some oversight that historically had rested with the Racing and Wagering Board, the Racing and Wagering Board still maintained significant oversight of

[48] In the wake of the Interim Report, which was by definition and design a preliminary review, the Inspector General conducted an investigation that encompassed a broad scope, including an extensive review of documents and sworn testimony from relevant witnesses.

[49] "NYRA fires Hayward and Kehoe after report on takeout mishap," by Matt Hegarty, *Daily Racing Form*, May 5, 2012.

NYRA tracks. Specifically, it licensed all NYRA employees and board members; reviewed and approved all simulcast contracts; received daily handle numbers for on-track and off-track betting; and, relevant to the instant investigation, approved any changes in takeout rates. The Racing and Wagering Board also possessed civil enforcement authority to ensure that racing associations, like NYRA, operated within the parameters of the Racing Law and rules promulgated by the Racing and Wagering Board.

Given its authority to monitor and enforce the racing laws, it is not surprising that the Racing and Wagering Board routinely assessed and commented on pending racing legislation for the governor's office. Although then Counsel Feuerstein could not recall if the Board commented on the June 2008 NYC OTB legislation which raised NYRA's takeout rates, he presumed that it did. Feuerstein related that he considered the takeout provisions of the legislation to be "significant." Legislative changes to the takeout rates were uncommon and the one percent increase was duly noted by those involved in horse racing, including, as noted above, by NYRA. On June 30, 2008, Feuerstein sent a letter to Viscusi reminding him that NYRA had to seek approval of the one percent takeout rate increase with the Racing and Wagering Board. When queried about sending the letter, Feuerstein characterized it as "good practice" rather than policy. Although the letter did not include mention of the sunset date of September 15, 2010, Feuerstein recalled awareness of it.

In fact, in the Racing and Wagering Board's 2008 Annual Report which was published on its website, the takeout increase and the sunset were discussed. Specifically, the Racing and Wagering Board was required by statute[50] to submit an annual report to the governor detailing its efforts of the preceding calendar year, which includes, among other things, legislation affecting the Racing and Wagering Board for that year. The Legislative Section of the 2008 Annual

[50] Chapter 346 of the Laws of 1973.

Report included discussion of the legislation that codified the 25-year franchise agreement with NYRA and created the Franchise Oversight Board. The Legislative Section also explained that Chapter 115 of the Laws of 2008 "amended (for 2 years) the takeout rates applicable to wagers placed on races conducted by the franchised racing corporation." [Parenthetical in original]

Given that the 2008 Annual Report clearly indicates that the Racing and Wagering Board's legal department read and analyzed the statute, the Inspector General inquired as to whether the Racing and Wagering Board employed a system to track and calendar applicable statutes and expiration dates. Feuerstein conceded that he did not calendar the sunset date and that he was primarily "responsible for legislative matters and these types of things." Another Racing and Wagering Board employee noted that these types of laws are almost always extended, and it was "unbelievable this one actually reverted." As a result, when the legislation expired, no one at the Racing and Wagering Board realized because, in contrast to when an extension of legislation occurs, no action was taken; rather, on September 15, 2010, the rates merely reverted to the 2008 rates by operation of law. When questioned how the Racing and Wagering Board had missed the expiration of the takeout rates, Feuerstein explained:

> Well, what happened is that none of the mechanisms that existed where this would have been picked up by Racing and Wagering Board employees proved satisfactory. In essence, the Board has never had staff stationed at the Board to monitor the Pari-Mutuel tax or calculations, at least that I can recall, calculations or application of Take Out rate. When the Take Out rate reverted, the Board did not have a process in place to periodically or even annually compare the statutory Take Out rate to the rate in effect.

As such, the legislative section of the 2010 Annual Report (dated July 2011) neglected to mention anything about the expiration of the one percent increase in the takeout rate and the reversion to the 2008 rates.[51] Moreover, unlike in 2008 when Feuerstein sent a letter to NYRA

[51] Of note, the legislative section of the 2009 Annual Report included reference to the extension of the expiration date of certain provisions of the Racing, Pari-Mutuel Wagering and Breeding Law.

as a reminder to seek approval from the Racing and Wagering Board to increase its takeout rates, no letter was sent to remind NYRA to request a decrease in the takeout rate for exotic wagers.

As a result of this takeout issue, the Racing and Wagering Board announced in its Interim Report that it planned to institute the following remedial measures:[52]

- The Board will include in its annual report a summary of statutes or provisions that have expired or reverted;
- The Board will annually review the qualifications of the auditors performing . . . audits;
- The Board will require all racetracks to submit takeout configuration reports on a periodic basis and the Board will verify the takeouts with the Racing Law;
- The Board will require racetracks to publish their takeout rates with a web link to the current statutory takeout sections of the law.

K. Multiple Layers of Auditors Failed to Recognize the Takeout Error

The Inspector General determined that the numerous internal and external auditors of NYRA and the auditors of United Tote, NYRA's totalisator company, failed to uncover NYRA's noncompliance with the statutory takeout rate for exotic wagers. The Inspector General further determined that NYRA's law department lacked proper controls to monitor takeout rates and other statutory rates, and these control deficiencies were not discovered by the internal audit department because it had never audited the law department's internal controls. The following is an analysis of the various auditors associated with NYRA.

NYRA Board Audit Committee

Members of NYRA's Board of Directors served on various committees which are empowered by the Board to perform enumerated functions. One such committee is the Audit Committee created, according to its Charter then in effect, to ensure "the integrity of the

[52] The Gaming Commission has adopted these remedial measures.

NYRA's financial reporting process and systems of internal controls regarding finance, accounting, operations and legal compliance." Specifically, the Audit Committee was tasked with the oversight of NYRA's accounting, financial reporting and statements, as well as its internal controls. The Audit Committee met on a quarterly basis, had direct contact with both internal and external auditors, and was charged with pre-approving the audit plans of NYRA's internal auditors. After receipt of any audit reports, and before they became final and disclosed to the public, the Audit Committee was required to evaluate the reports with the auditors who prepared them, either internal or external, and review the findings with management for its response to audit recommendations.

The Audit Committee also directly supervised the Director of Internal Audit and reviewed the activities of the internal audit department staff. This reporting arrangement is consistent with the Institute of Internal Auditors guidelines, which require that, "the internal audit activity is structurally independent and free from coercion by management." Administrative reasons may exist for the internal audit department to be accountable to the highest level person in the agency, but the internal audit department should otherwise answer and report to the Audit Committee.

Additionally, pursuant to the Racing Law, NYRA is required to retain an external auditor to ensure the accuracy of its financial statements, among other tasks. Revenue, composed almost exclusively of receipts from takeout, should have been included in this financial audit.

Finally, the NYRA Board has required audits of NYRA's totalisator company since approximately 2003; the Racing and Wagering Board only required an audit of the totalisator company since January 1, 2009.[53] The annual totalisator audit is conducted by an external

[53] The Gaming Commission has continued this requirement.

auditor retained by the totalisator vendor and submitted to both NYRA and the Racing and Wagering Board, which has been subsumed by the Gaming Commission.

As will be detailed below, while each of these three levels of auditors should have uncovered NYRA's failure to apply the correct statutory takeout rate for exotic bets, none of them made the discovery.

NYRA's Internal Audit Department

According to the 2008 Charter of NYRA's internal audit department, the mission of the internal audit department was to provide the Board of Directors and the Audit Committee with "reasonable assurance" that "NYRA's established policies and procedures are adequate, are being adhered to, and that these policies and procedures enable NYRA to achieve its goals." The Director of Internal Audit was required to establish a yearly audit plan which had to be approved by the Audit Committee. The internal audit department was specifically directed to include in its audit scope the integrity of internal controls relating to operating and financial information as well as statutory and regulatory compliance. To this end, the internal audit department was granted access to all NYRA documents, departments and employees.

William Varvaro served as NYRA's Director of Internal Audit from approximately 2005 until his death on June 11, 2011. Prior to his death, Varvaro suffered from a long-term illness which necessitated long absences from work. According to his subordinate staff, Varvaro, when unable to report to work, maintained contact with them through email and telephone communication. Audit Committee minutes indicate that when Varvaro could not attend meetings in person, he participated by telephone.

After Varvaro's death, NYRA did not appoint a new Director of Internal Audit. Instead, the management of the internal audit department was assumed by then Chief Financial Officer Ellen McClain. This structure was contrary to the Audit Committee Charter and the standards of the Institute of Internal Auditors which, as noted above, requires internal audit departments to be structurally independent from management. McClain's involvement in internal audit functions was pervasive: she became involved in the performance reviews of internal audit staff and dismissed at least one employee, which left a staff of two; she reviewed Audit Committee minutes before they were provided to Committee members; she oversaw the search for an outside company to perform the internal audit function in the wake of Varvaro's death;[54] and she directed the activities of Deloitte & Touche, LLP, once they were retained, to re-vamp the internal audit department, and then required that the subordinate staff report to an on-site Deloitte employee. [55]

The Inspector General reviewed the audit plans for calendar years 2008 through 2012, along with minutes of Audit Committee meetings and numerous internal audit reports. The audit plans for each year included an audit of the cash rooms at each NYRA track, an anti-money laundering audit, a NYRA Rewards audit, and an audit of the general ledger. Other than these specific audits, the internal audit department did not engage in financial audits and did not audit revenue. Instead, the finance department provided unaudited financial reports directly to the Audit Committee. The reports submitted by the finance department provided handle numbers

[54] According to James Heffernan, at some time during 2011, the Audit Committee became concerned about the functioning of the internal audit department. Part of the problem was the deterioration of the function during Varvaro's illness, but even more important was what Heffernan described as a series of confrontational interactions between Internal Audit and management that he asserted did not add value to the organization. Howard Foote, the UHY partner who was heavily involved with the internal audit department, stated that there was a "strained relationship between the finance department and internal auditors, as there typically are in all organizations." Foote stated that the finance department did not respond timely to the auditors and did not like the way internal auditors approached their audits.

[55] NYRA hired a new Director of Internal Audit who was formerly employed by Deloitte & Touche.

(the gross amount bet on races both on-track and through simulcast agreements) as well as revenue numbers. NYRA's largest revenue source by far was takeout from racing activities,[56] but specific takeout rates and the revenue applicable to each bet type were not presented to or discussed by the Audit Committee prior to the discovery of the takeout error at issue herein. Instead, the takeout rate presented in financial reports to the NYRA Board and Audit Committee consisted of a "blended," or average, rate, for all bet types.

The Inspector General interviewed the three former employees of the internal audit department. They each reported that they had worked only on those audits assigned to them and had no involvement in creating the audit plans. Moreover, each auditor was unaware of the work being conducted by his or her colleagues, a surprising revelation given the small number of staff employed in the internal audit department. Unless they worked with Varvaro on an audit, none of them knew of the work being done by him. The auditors were each asked whether they ever audited the takeout rate or revenue numbers from the finance department; all denied participating in such an audit. According to the internal audit staff, they were not involved in conducting any financial audit; rather, year-end financial audits were performed by the external auditors, UHY, LLP which was purportedly charged with reviewing the takeout rates. None of the employees knew if Varvaro himself reviewed takeout rates or legal compliance, but the Inspector General uncovered no evidence in the audit plans that he did so. The Inspector General determined that until the takeout issue was exposed in December 2011, no one in NYRA's internal audit department even looked at the takeout rates, let alone conducted any audit to assess their accuracy.[57]

[56] NYRA also obtains revenue from track admission fees, parking fees, and sales of food and sundry items.
[57] Prior to 2012, the internal audit department received the SAS 70 and SSAE reports for the tote provider, but only reviewed the information technology assertions contained in the report, rather than each assertion and conclusion. According to one member of the internal audit department, NYRA included the SAS 70 review of its totalisator

Not only did the internal audit department fail to review the takeout rate, it similarly failed to review the internal controls of the law department that was specifically charged with statutory compliance. According to law department internal policy, "General Counsel will make a diligent effort to identify those laws, rules, and regulations . . . which pertain to NYRA's operations, and inform NYRA management of its responsibility to comply." Other than ensuring that internal controls for the law department had been filed with the Franchise Oversight Board and participating in the yearly anti-money laundering audit with Viscusi, the internal audit staff did not conduct a single audit of the law department or its internal controls. One internal auditor affirmatively stated that NYRA had no controls in place to ensure that the correct takeout rates were being charged. Viscusi, who has been an attorney in NYRA's law department since 2002, confirmed that the internal audit department never audited the law department or its internal controls. In fact, no one at NYRA audited or reviewed the issue of statutory compliance until after the takeout issue was reported to NYRA by the Racing and Wagering Board, and then only in response to a demand by UHY in 2012 that it do so.

If internal audit had reviewed the law department's internal controls, it would have found, as the Inspector General did, that no system was in place to periodically check compliance with statutory rates or to properly calendar important legislative dates like the sunset provision relating to takeout rates. After the disclosure of its noncompliance with the statutory reduction in takeout rates, when the law department undertook a rate review consistent with its obligations under NYRA's policies, NYRA uncovered, in addition to the takeout issue, five years of other statutory non-compliances and determined that it had overpaid its required

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company's internal controls in their service provider's contract so that that the internal audit department would not have to audit that vendor. That level of review changed after the takeout issue was uncovered in December 2011.

statutory contribution to the New York State Thoroughbred Breeding and Development Fund by $1,196,994 and underpaid its pari-mutuel and other taxes in the amount of $327,129.

The Inspector General interviewed James Heffernan, the chair of the Audit Committee from October 2008 to the end of 2010. According to its Charter then in effect, the Audit Committee was required to meet at least annually with NYRA's Counsel to review "any legal matters that could have a significant impact on the organization's financial statements [and] NYRA's compliance with applicable laws and regulations." When asked what he thought should have been done by internal audit regarding the takeout rate, Heffernan stated that internal audit should have been contacting the law department "on a regular basis" to determine whether it had "reviewed the statute that went through all the takeout rates and signed off on it." It was the Audit Committee chaired by Heffernan, however, that was tasked with meeting with Counsel and failed to do so,[58] and the Audit Committee that repeatedly approved the audit plans each year from 2008 to 2011,[59] yet failed to require any such review of takeout rates. [60]

UHY, LLP – External Auditor of NYRA

Pursuant to the Racing Law, NYRA is required to retain a certified public accountant to audit NYRA's year-end financial statements and to render an opinion regarding the efficacy of NYRA's internal controls that are filed with the appropriate regulatory agency. From 2005 until

[58] The Inspector General has been provided with no documentation from NYRA showing that any meeting between Counsel and the Audit Committee took place for the purpose of reviewing statutory compliance, nor could Viscusi, who attended all the Audit Committee meetings and Board meetings, recall such a meeting prior to December 2011.
[59] The Audit Plan was never approved for 2010. Only one Audit Committee member, Heffernan, attended the April 2010 meeting where the plan was presented and he could not vote on the plan without a quorum present. No approval took place during any of the other meetings in 2010.
[60] Heffernan asserted that he viewed the risk of a takeout error as small because of the presence of a New York State Department of Taxation and Finance employee on site who checked the rates on a daily basis. Upon being confronted with the Tax employee's retirement two years earlier, Heffernan conceded that he was unaware that the Tax employee had retired until he read about it in the newspaper in May 2012. *See*, "A Missed Set of Eyes," by James Odato, *Times Union*, May 6, 2012. Furthermore, in 1991, daily reports began to be sent by computer from the tote provider directly. After that, the Tax employee no longer reviewed the rates as part of his job duties; therefore, the likelihood that he would have discovered the discrepancy was minimal.

the end of the audit work that includes calendar year 2011, UHY was retained as the external auditors for NYRA.[61] UHY engaged in compliance audits for NYRA, audits of NYRA's year-end financial statements, employee pension fund audits, and prepared various NYRA tax forms and government filings. [62]

UHY prepared the audit plans for its NYRA engagement by utilizing a standardized software audit plan prepared by a national accounting firm vendor and then altering that plan to fit NYRA. It also relied on its previous audits to plan its successive audits. Howard Foote, the UHY partner in charge of the NYRA account from 2005 through the 2010 financial statement review, and still involved with NYRA audits until mid-2012, explained that UHY reported to the Audit Committee and routinely attended Audit Committee meetings as part of its audit function. In fact, Audit Committee minutes consistently reflect the presence of UHY employees. At the outset of each year's engagement, UHY provided the Audit Committee with a PowerPoint presentation of its audit plan, and then answered questions and received comment. UHY also obtained a letter from NYRA management for each engagement that, among other things, certified NYRA's compliance with statutes and regulations; certified that NYRA's financial statements were prepared in accordance with generally accepted accounting principles; asserted that management was unaware of any instances of fraud at the corporation; and stated that it has not been notified by its regulatory oversight agency of noncompliance in financial reporting practices.

In performing its external audits, UHY relied upon NYRA's internal auditors to obtain certain information. According to UHY, it engaged in a process of testing and qualifying the internal audit department staff. Notwithstanding that assertion, one of the internal audit

[61] During the pendency of the Inspector General's investigation, NYRA rebid its external audit function and did not choose UHY.
[62] UHY was also the external auditor for Capital OTB and the now-defunct New York City OTB.

department staff stated that she was never interviewed by UHY until 2012. Another stated that he was never interviewed by UHY or asked his qualifications. UHY did apparently meet with various members of NYRA management to obtain information for its audit, including members of the finance department and Viscusi from the law department.

1. UHY's Compliance Audit

The statutorily required annual Compliance Audit consists of a report from an independent certified public accountant assessing NYRA's internal controls relating to its accounting and business management practices and its compliance with those controls relevant to its audited financial statements. The independent certified public accountant should identify deviations from generally accepted accounting principles and identify those controls which are ineffective. According to the American Institute of Certified Public Accountants (AICPA), a control deficiency exists "when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis." The Inspector General determined that, contrary to the statutory requirement that UHY identify ineffective NYRA internal controls, at least in the case of the law department, UHY failed to inquire into controls over statutory rate compliance until after the December 2011 discovery of the takeout issue.

According to UHY staff, the purpose of the NYRA compliance audit was to determine if the organization complies with its own internal policies and procedures, not to determine whether NYRA complies with applicable statutes or regulations. As such, a large component of the compliance audits analyzed the functioning of NYRA's internal audit department. Specifically, UHY obtained and reviewed NYRA's audit plans and obtained and sampled its

internal audit reports along with the work papers, the underlying documentation and calculations on which the final report is based, for those audits. Each year, UHY chose a different subset of internal audit department work, and reviewed the work papers for the audits and retested some of the work conducted. Consistently, UHY did not report any material deficiencies in NYRA's compliance with its internal controls.[63]

To the extent that the compliance audit required UHY to review NYRA's internal controls, the audit was deficient. Although it listed in its compliance reports for the years 2009, 2010 and 2011 that NYRA properly filed its internal controls with its regulatory oversight agency, UHY only actually confirmed this fact once at the Racing and Wagering Board, and never at the Franchise Oversight Board after the filing requirement was transferred to that board. After confirming the filing on a single occasion, UHY thereafter relied solely on NYRA to inform it whether any new policies were properly filed. In addition, it is clear that no one reviewed the content of the internal controls that had been purportedly filed. Even a cursory review would have revealed the deficiencies of the law department internal controls, which merely stated policy objectives but did not describe the actual controls employed to achieve the objectives. For example, concerning compliance, the internal control policy vaguely stated, "The General Counsel will make a diligent effort to identify those laws, rules and regulations not specifically covered in this section, which pertain to NYRA's operations, and inform NYRA's

[63] UHY did note a few issues but deemed them to be immaterial. Foote stated that he noticed that after Varvaro became ill, and especially in 2011, the internal audit department fell behind in some of its audits. Additionally, in its 2010 and 2011 compliance reports, UHY discovered that seven members of NYRA's Board of Directors: Stuart Janney, Robert Evans, Ogden Mills Phipps, Barry Ostranger, Richard Violette, Michael Dubb and Leonard Riggio, had failed to disclose on their annual ethics forms that they owned horses that raced on NYRA-operated tracks. The purpose of the disclosure is to guard against any conflicts of interest in financial and contractual transactions that may arise that could warrant recusal. Other than identifying the board members who did not acknowledge ownership of horses, UHY conducted no testing to determine if there were transactions that could have been affected by the failure to disclose, but rather merely concluded that the failure to disclose did not have a material impact on the financial statements. Therefore, this failure to disclose was not mentioned in NYRA's financial statements.

management of its obligation to comply." In another section regarding the duties of in-house legal staff, the policy stated that, "the Law Department also works to ensure that the activities of NYRA's various departments are compliant with all statutory and regulatory requirements." Neither objective described the control to be used to ensure that the policy objective will be met. An appropriate control would refer to a procedure, like a calendaring system, to ensure compliance with deadlines and statutory effective dates. No one at UHY interviewed by the Inspector General was aware of any such control. Moreover, UHY was unaware if NYRA's internal audit department ever conducted an audit of NYRA's compliance with statutes or regulations. In falling short of performing this function appropriately, UHY too failed to uncover NYRA's clear non-compliance with its statutory obligations. Accordingly, the Inspector General has determined that UHY's compliance audits failed to achieve their stated objectives.

2. UHY's Financial Review

The Inspector General determined that, with regard to the yearly audit of NYRA's financial statements, UHY failed to engage in an audit sufficient to test the accuracy of NYRA's revenue and statutory payment calculations which underlie its financial statements. The purpose of the audit of NYRA's financial statements, as with any organization, is for the independent auditor to issue an opinion that the financial statements are not materially misstated and are consistent with generally accepted accounting principles. Materiality is a statement of professional judgment and has been defined by the Financial Accounting Standards Board as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying

on the information would have been changed or influenced by the omission or misstatements." For the financial audit of NYRA revenue, materiality was defined by UHY as a percentage of gross income, approximately one percent.

A misstatement can result from an error, which can range from simple miscalculations and omissions to errors in judgment, or even fraud. The auditor's obligation to detect the error varies based on the level of the risk or materiality of the possible misstatement. High-risk items require greater testing for the auditor to determine that there exists a minimal likelihood of error. Every employee of UHY involved in its audit of NYRA agreed that revenue, and in particular takeout revenue, was a high-risk item. Foote, the UHY partner in charge of the 2010 revenue audit,[64] explained that takeout revenue was not merely important because it constitutes the majority of NYRA's revenue, but because it "affects the balance sheet also in terms of the settlements and the income and the sharing of revenues with others." The external auditors do not check every transaction, however, but instead use a sampling technique to arrive at a "reasonable basis" for their conclusions, and "not an absolute basis."

The Inspector General interviewed several UHY principals and employees involved in the financial audits of NYRA. According to Foote, to support their conclusions and opinions regarding financial reports, external auditors should gather "sufficient appropriate evidence" by a process of "inquiry and observation and confirmation." In the confirmation process, Foote instructed that "third-party confirmation is seen as being one of the highest levels of professional standards you can seek." Foote declared that the reliability of the third party confirmation

[64] By the time UHY audited the 2011 financial statements after the end of the 2011 calendar year, the error in the takeout rate had been uncovered by the Racing and Wagering Board and disclosed to NYRA management. Therefore, UHY already knew of a misstatement of revenue. That audit was reviewed by the Inspector General to note the steps taken to deal with a known error, but it was not instructive to uncover the reasons for the 15-month takeout rate error.

improved when that party was independent and not affected by the outcome of the audit. Foote confirmed that he approved the audit plan for the 2010 financial audit.

For the 2010 calendar year audits, the same auditor conducted tests for both the compliance audit and the year-end financial report audit. With regard to auditing whether NYRA was using the correct statutorily mandated takeout rates, the UHY Auditor initially asked Steven Hofmann, a former NYRA revenue analyst, for the takeout rates. She decided to seek the rates from Hofmann for the 2010 financial audit because the audit notes from the prior year indicated that he had provided those rates to UHY. The UHY Auditor received the chart created by Hofmann discussed earlier in this report. As noted, the chart has a section entitled "Take-Out Range" and the range listed for exotic wagers is 15-25 percent. However, that range is listed under Racing Law section 229, the section of the law that dealt with NYRA takeout rates prior to the 2008 amendment to the law that codified the franchise agreement and placed the takeout rates under section 238 instead. The chart also included a section entitled "current rates," and under the exotic wagers is listed "26.0%." The UHY Auditor stated that when she looked at the sheet, she only paid attention to the section listing current rates as applied by NYRA, and ignored the statutory ranges of 15-25 percent listed to the left. Even though Hofmann explained that he had not updated the chart since 2008 and that he was unaware that the takeout rates had reverted to the pre-2008 ranges listed therein, the UHY auditor was unaware that the range listed on the chart was from a previous statute when she conducted her review. Essentially, she ignored the range that was actually correct and made no further inquiries about the statutory range.

After she obtained the takeout rate, the UHY Auditor tested the reasonableness of NYRA commissions and expenses by obtaining the statutory citation from Hofmann, and then locating a

copy of the statute on the Internet and reading it. Unfortunately, she misunderstood the statutory printout and did not follow an asterisk to the effective dates of the various listed rates. In turn, she incorrectly determined that the 26 percent rate for exotic wagers that NYRA was charging was correct. She then wrote in her report that the 26 percent commission was reasonable and complied with prior years.

Both the UHY Auditor and Foote declared her work reasonable based on NYRA's management assertions associated with UHY's yearly audits. Of note, UHY did not seek guidance from NYRA's law department about the takeout rate, or from any independent third party source. At the time the UHY Auditor researched and tested the takeout rates, she had never been involved in an audit dealing with statutory rate compliance, nor was she an attorney, although Foote claimed that her work papers were reviewed and approved by UHY management. Moreover, the UHY Auditor did not seek assistance from an attorney at UHY; she did not even know if UHY employed any attorneys. In fact, UHY does employ attorneys on staff. Foote told investigators, however, that UHY would not utilize its own in-house attorneys to look at a statute because "our attorneys . . . to my knowledge, have never been used on engagements." Another member of UHY's NYRA audit team stated that UHY had an auditor look at the statute rather than an attorney because professional standards do not require auditors to have an attorney review the law. Notwithstanding, no bar to it exists either.

According to the AICPA, "Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity." As noted earlier, Foote himself stated that, "third party confirmation is seen as being one of the highest levels of professional standards." Despite this acknowledgement, UHY's auditors on the NYRA engagement never contacted the Racing and Wagering Board to determine if NYRA was in compliance with the

takeout rates. In fact, the UHY Auditor was unaware of any role that the Racing and Wagering Board had in setting or regulating the takeout rates. When the Inspector General asked Foote why he or his staff never contacted any third party regulator[65] or entity to obtain the takeout rates, he gave various explanations. Foote alternately told investigators that UHY's reliance on NYRA's staff was reasonable based on UHY's four- to five-year relationship with NYRA, UHY's attendance at NYRA Audit Committee meetings, and discussions with NYRA staff and integrity counsel. Foote asserted that he believed NYRA's employees[66] when they provided UHY the takeout rates at the beginning of each financial audit and when NYRA asserted to UHY that they were in compliance with applicable statutes and regulations. In hindsight, Foote admitted that his reliance on NYRA employees was a mistake. Foote then attempted to downplay the mistake by claiming that since the takeout rates expired on September 15, 2010, the takeout overcharge for 2010 totaled only approximately $200,000, significantly less than the approximately one percent requirement to be deemed material. He proclaimed, therefore, that UHY's opinion that the financial statements were not materially misstated was still technically correct.

Foote also claimed that UHY did in fact approach various third parties to confirm NYRA's takeout rates. Foote stated that UHY received third-party confirmations of financial information from Neil Getnick, NYRA's then integrity counsel – clearly not an independent third-party source as contemplated by best practices. He also claimed that UHY reviewed simulcast contracts that included the takeout rates in effect at the time of the signing of the

[65] The Inspector General makes no conclusion whether, after an inquiry by UHY, the Racing and Wagering Board would have provided UHY with the correct rates. The Racing and Wagering Board has already admitted that it did not uncover the failure to comply until the issue was raised by the Office of the State Comptroller.

[66] Due professional care requires that an auditor employ professional skepticism. According to the AICPA, "the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest." AU §230.07-09

contracts. Those contracts, however, should not have been considered an independent source of information upon which UHY could rely because the takeout rates listed in the simulcast agreements were inserted by NYRA staff members. Notwithstanding, a careful review of the simulcast contracts would have placed UHY on notice that the rates were potentially subject to change, because the simulcast agreements specifically limited the application of the takeout rates included in the contracts "for so long as the applicable increased takeout rates that went into effect on September 15, 2008 are in full effect." Clearly, such careful review did not occur.

UHY also claimed that it relied on the audit of United Tote completed by Berry Dunn McNeil & Parker (Berry Dunn) for audit period October 1, 2009, through September 30, 2010, in preparing UHY's 2010 financial statement audit. UHY received the audit from NYRA's internal audit staff along with the internal audit department review of Berry Dunn's work. Foote claimed that UHY relied upon Berry Dunn's audit even though he admitted he did not know if Berry Dunn confirmed the takeout rate or when testing of the takeout rate was conducted. [67] The UHY auditor stated that she only used Berry Dunn documentation to compare the rates it memorialized to the rates relayed to her by NYRA's revenue analyst to determine if they were consistent; not to determine if either set of rates was correct.

3. UHY's Fraud Interviews

In addition to obtaining the rates from NYRA's revenue analyst and the initial statements from NYRA's management that it was in compliance with applicable state statutes and regulations, UHY engaged in fraud interviews with various staff at NYRA. A standard question

[67] At most, the statutory takeout rate decrease for exotics would only have been applicable for 15 days of Berry Dunn's audit period, i.e. from September 15, 2010, when the statutory increase expired to September 30, 2010, when Berry Dunn's audit period ended.

in fraud interviews[68] was whether the organization under audit is in compliance with all applicable statutes and regulations and whether the interviewee is aware of any fraud in the organization. For the 2010 audit, UHY interviewed Viscusi on March 5, 2011, and again on November 9, 2011. On both occasions, Viscusi stated that NYRA was in compliance with all laws and regulations applicable to it. Hindsight establishes that Viscusi was wrong. The Inspector General did not uncover any evidence that Viscusi conducted any research on this issue before making these statements to UHY, nor did Viscusi assert otherwise. Despite his awareness that UHY relied upon the statements he made in his numerous fraud interviews since 2005, Viscusi told the Inspector General that he did not prepare for these interviews and often received little to no warning that they were going to take place.

Viscusi was again interviewed by UHY for its 2011 financial audit. Consistent with previous years, he was again asked about any known statutory non-compliance or fraud. By the time of this interview, mid-March 2012 and after the discovery of NYRA's noncompliance with the statutorily mandated exotic takeout rate, Viscusi was engaged in an intensive statutory rate review. He advised the interviewer, the same UHY auditor who had conducted his November 2011 interview, that he was unaware of any statutory non-compliance other than what he was researching at the time. The UHY Auditor confirmed Viscusi's representation of the conversation when she was interviewed by the Inspector General. However, her testimony differed from what she wrote on her report included in UHY's work papers. In that report, the UHY auditor indicated that Viscusi stated "he is still not aware of any fraud or material non-compliance with laws and regulations." This incorrect entry in the report casts doubt over the

[68] The interviews are not recorded; nor are the witnesses placed under oath or asked if they concur with what is written on the document. The UHY Auditor testified that it was her practice to take notes of the interviews and stated that she attempted to memorialize in her notes the exact information told to her by the witness.

utility of fraud interviews in UHY's audit plan, at least to the extent that this auditor was involved in the preparation of the report.

Former NYRA General Counsel Patrick Kehoe was also the subject of fraud interviews in 2011, but these interviews were conducted by a UHY partner, Alex Zhang. According to Zhang, Kehoe incorrectly asserted that NYRA was in compliance with applicable statutes and regulations.

After UHY became aware of the takeout rate issue, and despite asking for a rate review from NYRA, UHY still, during the audit of the 2011 financial statements, did not seek confirmation of the statutory rates from an independent third party, namely the Racing and Wagering Board, but again inquired of Viscusi for the rates. When asked what UHY did to ensure that Viscusi provided accurate rates this time, the UHY auditor replied that UHY placed a footnote in its review of NYRA's financial statements to alert the reader to an ongoing rate review, so it was allegedly unnecessary for UHY to make sure that it had the correct rates in 2012 .

UHY's heavy reliance on its client, as it discovered to its detriment, was sorely misplaced. Although UHY performed compliance audits, financial audits and tax work for NYRA, it failed to uncover that NYRA was out of compliance with statutory takeout rates, statutorily proscribed contribution rates or New York State pari-mutuel taxes. Rather than employing any professional skepticism, or reaching out to any independent third parties, UHY depended solely on its client when other options were readily available – a practice contrary to standard accounting principles.

External Audit of United Tote

In order to operate its wagering system, NYRA contracted with United Tote[69] for totalisator services. A totalisator system, otherwise called a tote system, rapidly calculates wagers across betting types to calculate pool odds for each type of wager. The system records all bets and issues tickets to on-track bettors; records telephone or computer wagers into a computer system; and will honor a winning ticket for payment or record a win or loss in a computerized account. At the end of the day, United Tote prepared various reports for NYRA regarding the races run on the system, and calculated total handle, NYRA's commissions, and other financial numbers. It also provided transactional information to the New York State Department of Taxation and Finance. As part of its contract with NYRA, United Tote provided NYRA with a yearly audit of its tote services.

Also as part of its contract with NYRA, United Tote was required to reimburse NYRA or its bettors for any financial discrepancy due to its own error. Realizing the importance of the takeout rate and United Tote's potential exposure, United Tote established a system of daily confirmation of the applicable takeout rates by managers in NYRA's pari-mutuel department before the commencement of racing. NYRA pari-mutuel managers confirmed the wrong exotic takeout rate on every race day for a period of 15 months.

United Tote and its employees assigned to NYRA are required to be licensed by the Racing and Wagering Board to conduct tote services in New York. Under that license, starting in 2009, United Tote has been required to submit on a yearly basis a SAS 70 report or "other report approved by the [Racing and Wagering] Board." According to the AICPA, the SAS 70

[69] The Inspector General found no wrongdoing by United Tote regarding the takeout noncompliance at issue. Moreover, United Tote complied fully with the Inspector General's subpoenas, willingly produced witnesses from outside New York State and assisted in the investigation. In 2012, during the pendency of the Inspector General's investigation, NYRA rebid its totalisator contract. United Tote was not selected by NYRA.

provides guidance to independent auditors who review financial statements for service organizations, like United Tote. Not only did NYRA receive the SAS 70 performed for United Tote to ensure that those services were properly provided, but as directed by regulation, the Racing and Wagering Board also received a copy.

To provide additional guidance regarding its expectations for the SAS 70 report, the Racing and Wagering Board created "SAS 70 Type II Totalisator Audit Requirements," effective January 1, 2009. The requirements are divided into eight control objectives. For each of the eight control objectives, the Racing and Wagering Board identified numerous control procedures to be tested, and then cross-referenced those procedures to the applicable New York State regulation, when applicable. Control Objective S-4 of Racing and Wagering Board's Totalisator Audit Requirements directs auditors to examine whether "controls provide reasonable assurance that transactions are completely and accurately processed, posted, and summarized for reporting purposes." As part of that broad objective, sub-objective S-4(x) requires auditors to review whether "Commissions are calculated using appropriate statutory take-out rates (retention / take-out)." The Totalisator Audit Requirements were mailed to United Tote on July 31, 2008, well ahead of the January 1, 2009 effective date, and were consequently found by the Inspector General in each of United Tote's external auditors' working papers.

In April 2010, the AICPA issued new standards for independent auditors who review service organization internal controls relating to financial information for reporting periods ending on or after June 15, 2011. This new standard, called SSAE 16, was applicable to United Tote for its reporting period ending September 30, 2011.

After AICPA issued SSAE 16, on February 22, 2011, Thomas Casaregola, then Director of Audits and Investigations for the Racing and Wagering Board, wrote a letter to the three tote

companies that conduct business in New York State, including United Tote. The Inspector General confirmed that United Tote received the letter and gave it to PricewaterhouseCoopers, United Tote's independent auditor for the period ending September 30, 2011. The letter noted the new accounting standards, and reminded the tote companies that in addition to the newly issued standards, the Racing and Wagering Board maintained, since 2008, its own standards regarding the independent audits of tote companies licensed to work in New York.[70] As an attachment to the letter, Casaregola provided the tote companies with the Totalisator Audit Requirements effective January 1, 2009. Casaregola stated that he issued the letter "acknowledging that the American Institute of CPAs changed the requirements somewhat . . . we told them which type of audit under that guideline we want them to issue and by the way, you are still required to follow these same standards that we had issued back several years ago."[71]

United Tote necessarily relied on NYRA for various input values, including the takeout rate, from which it calculated the wager pools and payouts. Takeout rates were set by the New York State Racing and Wagering Board at the request of NYRA. Each time the Racing and Wagering Board approved a new rate, Viscusi sent a letter with the notice of approval attached to United Tote and requested that it confirm the change in writing. Upon receipt of the direction to change the takeout rate, United Tote wrote a letter to NYRA confirming the change and attached to that letter a configuration report showing the specific takeout rate assigned to each bet type. According to United Tote's then President, Benjamin Murr, United Tote did not change the takeout rate without written direction from NYRA.

[70] The original SAS 70 requirements were applicable to service providers, but not specific to a totalisator company. The Racing and Wagering Board approved the additional standards contained in the *SAS70 Type II Totalisator Audit Requirements* in 2008 and they became effective on January 1, 2009.

[71] Casaregola, himself a CPA and a Certified Fraud Examiner, stated that the Racing and Wagering Board relied upon these independent audits of the tote companies so that the Racing and Wagering Board did not have to audit them on anything other than an exception basis.

In addition, consistent with Racing and Wagering Board regulations, Stephen Makovich, United Tote's Director of New York Operations, sent NYRA another copy of the configuration report showing the specific takeout rate for each bet type each day before racing began. Although not required by the regulations, Makovich required an acknowledgment of the applicable daily configuration report before racing commenced on each race day. As part of the acknowledgement, Makovich required that a manager in the NYRA pari-mutuel department sign the configuration report and the race card to ensure their accuracy. Makovich told the Inspector General that "United Tote will not perform or open or enable any wagering on their event until those reports are returned, signed, checked to United Tote." In Makovich's opinion, the procedure of sending the reports to NYRA and receiving them back signed by a NYRA manager was United Tote's internal control to ensure the accuracy of the takeout rates.

United Tote External Auditors Berry Dunn

Berry Dunn McNeil and Parker ("Berry Dunn") was United Tote's external auditor at the time that the Racing and Wagering Board issued its Totalisator Audit Requirements effective January 1, 2009. Prior to preparing its first report under the new standard, Mark Caiazzo, a partner in the firm of Berry Dunn, met in Albany with employees of the Racing and Wagering Board in order to understand and prepare the audit consistent with those requirements. According to Casaregola, Caiazzo asked him if there was anything that he was required to do in addition to the standard SAS 70 requirements and Casaregola discussed the additional requirements with Caiazzo and followed up with email correspondence.

In its "Report on Controls Placed in Operation and Tests of Operating Effectiveness" for the period of October 1, 2009, through September 30, 2010, issued on October 29, 2010, Berry

Dunn was required to test the suitability of the design and operating effectiveness of the internal controls United Tote was utilizing to ensure takeout rates were properly calculated using appropriate rates. United Tote reportedly had in place three internal control activities relevant to that objective: (1) "Percentages for commissions . . . are set in the server configuration file in accordance with NY requirements"; (2) "Commissions are calculated at the pool level and partitioned among contributing sources"; and (3) "The Tote system uses the percentages in the configuration file when calculating breakage, take out, and payout." To test United Tote's controls, Berry Dunn verified that various reports required by the Racing Law were in fact generated by United Tote and sent to NYRA. One such report, the previously mentioned configuration report, contains a sub-report called "Server Commission" that lists the takeout rates applied to each type of bet at each track. Berry Dunn also verified that the tote system accurately calculated commissions, based on the takeout rates programmed in the tote system. Berry Dunn concluded that there were "no relevant exceptions" to these controls. The Inspector General makes no finding regarding Berry Dunn's testing to determine whether United Tote's system accurately performed its required mathematical functions.

Regarding whether the takeout rates were properly set in the configuration report, Caiazzo admitted that Berry Dunn did nothing to test whether the takeout rates conformed to New York statutory requirements. In a sworn affidavit submitted to the Inspector General,[72] Caiazzo claimed Berry Dunn "Inspected Operator Checklists and Operator Live Sheets for a sample of 20 days during the audit period to determine that documentation was completed appropriately," and "Inspected the Event Program and Configuration reports (including

[72] Berry Dunn is located in Maine and was not a contractor with the State of New York, and therefore the company and its employees do not fall under the authority of the Inspector General. Nevertheless, Berry Dunn agreed to provide the Inspector General with working papers supporting its SAS 70 of United Tote. In lieu of providing direct testimony, Berry Dunn provided a sworn affidavit, dated September 7, 2012, and signed by Mark Caiazzo, the Berry Dunn engagement partner on the report.

commissions) for a sample of 20 days during the audit period to determine that reports were generated for the [NYRA] Mutuel Department." Berry Dunn provided a work paper listing the randomly selected sample dates, ranging from November 19, 2009, to September 8, 2010. Berry Dunn also provided an example of a "Live 1st Shift Setup Checklist" dated February 4, 2010, and a Configuration Report dated February 28, 2010. Both documents have handwritten signatures or initials purportedly from a NYRA representative reflecting NYRA's review of the documents.

While Berry Dunn's testing examined whether required reports, including configuration reports, were generated for NYRA by United Tote, it did not examine whether the takeout rates in those reports were set "in accordance with NY requirements" as it claimed in its October 2010 report. Caiazzo admitted to the Inspector General that Berry Dunn did not verify that the takeout rates programmed in United Tote's system conformed to New York State statutory requirements. According to Caiazzo, Berry Dunn "considered the notification and verification of rates, commission, etc. the responsibility of the customer [NYRA] and accordingly did not independently verify the commission percentages to published rates." Notwithstanding, this admission directly conflicts with Berry Dunn's declaration in its October 2010 report that it "Inspected server configuration files to determine that percentages are properly set in files."

External Audit of United Tote by PricewaterhouseCoopers

In 2010, United Tote's parent company merged into Churchill Downs, Inc. For the report ending September 30, 2010, United Tote permitted Berry Dunn to complete the review that had already commenced. After that report, United Tote engaged PricewaterhouseCoopers ("PwC"), Churchill Downs' auditors, to perform the totalisator audit.

On October 31, 2011, PwC issued a "Report on Controls Placed in Operation and Tests of Operating Effectiveness" at NYRA facilities covering the period January 1, 2011, through September 30, 2011.[73] With regard to takeout, the report stated that the control at issue was that "percentages for commission . . . are set in the server configuration file in accordance with NY requirements." The control referenced control objective S-4(x) in the audit requirements provided to United Tote by the Racing and Wagering Board and provided to PwC by United Tote and contained in its work papers. In its report, PwC indicated that it performed two types of tests on this control: inspection and re-performance. The re-performance is a test which ensures that the computer manipulates the input variables to arrive at the correct answer. The inspection, according to the report, consisted of "inspected server configuration files for evidence that percentages are properly set in files." According to PwC's risk assessment matrix for the engagement, takeout was a high risk item. The engagement partner for PwC, Jeffrey Fox, told the Inspector General that takeout was a high risk item because it has "a direct impact on the financial statements of NYRA." According to Fox, when auditing a high risk item, "we should either draw a larger sample or we should look for increased evidence." Fox explained that a sufficient sample size to test a daily control for NYRA's operations, assuming 250 days of racing a year would be "30 to 60 if we wanted to test the daily control." PwC assigned two auditors, an Experienced Associate and a Senior Associate,[74] to United Tote's offices at the Belmont racetrack in September 2011 to test takeout, referred to by PwC as "commission."

The Inspector General takes no exception to the re-performance portion of the testing conducted by PwC; no basis exists to conclude that the computer program utilized by United

[73] United Tote issued a gap letter stating that no audit was conducted for the three months of October –December 2010.

[74] An Experienced Associate is someone with at least one year of experience with PwC; a Senior Associate is more experienced and oversees the team of other associates.

Tote did not properly perform the mathematical functions that it was designed to conduct. The Inspector General is concerned with the inspection portion of the testing which should have ensured that the variables input into the United Tote system, in this case the takeout rates, were correct. Initially, the Experienced Associate merely confirmed that a number had been entered into the system for each of the takeout rates by referring to the configuration report. According to the Experienced Associate, she received a "coaching note"[75] from one of her superiors at PwC stating that this action was insufficient testing for inspection and was told to check the rates against "something."

The two on-site auditors decided that they should compare the rates in the configuration report against the statutory rates. Before they conducted the comparison, they discussed their plan with a PwC manager and a PwC partner, Doug Torline, who approved the planned comparison. After this discussion, the on-site auditors engaged in what the Experienced Auditor called a "reasonableness test."[76] As a first step, on September 17, 2011, the Senior Associate found the statutory rates and the Experienced Associate entered them, with a copy of the statute, into the working papers. The team then obtained a copy of the configuration report from September 15, 2011, and used that as a comparison, noting that the work was being done under control objective of S-4(x). The Experienced Associate stated that they tested the rates as an "aggregate." In other words, the on-site auditors obtained the correct statute which, depending on the type of bet, had possible takeout rates ranging in the aggregate from 12 to 36 percent, and compared that to the lowest and highest rates in the configuration report which were 16 and 28,

[75] A "coaching note" was described by PwC's counsel as a "to do" item which, once completed, is automatically deleted by PwC's computer system. The Inspector General was advised that this note is irretrievable, and thus was not produced in response to the Inspector General's subpoena.

[76] A test of reasonableness does not apply to a statute; such a test is more applicable to a mathematical calculation, like an estimate.

respectively. According to the Senior Associate, there was nothing, "outside that range or grossly . . . misstated."

The Senior Associate admitted that the on-site auditors, "didn't look . . . one by one" at the takeout rates. When asked why she didn't check the rates against the specific bet type, the Experienced Associate said that she was instructed to conduct a reasonableness test but did not know the basis for the instruction nor could she recall who had instructed her to do so. The Experienced Associate admitted that she did not know which bet type was applicable to each takeout rate and was unsure how long it would have taken her to research that issue regarding the 12 bet types against four different rates included in the configuration report she reviewed. She did testify, however, that she spent 600 hours on United Tote work. Based on the interviews of PwC's two on-site auditors, the Inspector General determined that PwC failed to conduct a thorough review of the takeout rates. While the auditors accessed the correct statute with the correct rates, their inspection was inadequate to uncover the takeout rate error.

The Inspector General then interviewed Jeffrey Fox, the engagement partner for PwC on the United Tote engagement, regarding the Inspector General's findings. Initially, Fox claimed that PwC confirmed that the takeout rates were correct "based on NYRA feedback," but then admitted that PwC never received feedback from NYRA. Fox then claimed that United Tote does not have a control to test the takeout rate. When confronted with the fact that his subordinates had described the daily submission of the configuration report to NYRA, Fox conceded that United Tote has "the control that happens daily." Fox continued "Every day I know that [United Tote] sends a report to NYRA that indicates the day's races and the projected commissions and takeout rates. It has them listed out by race-betting type and that report is signed by NYRA and sent back to [United Tote]." He claimed that he became aware of this

procedure during the planning phase of the engagement. He further admitted that PwC only saw a single report and that no copy of the report exists in PwC's work papers. Fox conceded that such support should have been included in the work papers. Compounding the problem, neither Fox nor the on-site auditors confirmed that NYRA received the daily configuration report transmissions or checked to see if they were endorsed by NYRA and returned to United Tote. Despite the fact that Fox admitted that United Tote retained "file drawers full of the returns," Fox conceded that PwC did not look at the returned configuration reports because he had unilaterally decided that the control belonged to NYRA, not United Tote.[77] Upon being confronted with this obvious testing flaw, Fox finally admitted that his staff should have looked at a "couple" of the reports showing the referral of the configuration report to NYRA because "you should understand the process in order to design the test." Fox ultimately admitted that there was no reference at all to examining the proof that the configuration reports were sent from United Tote to NYRA as part of the inspection in connection with control objective S-4(x) in the work papers.

In addition to the Inspector General's above-noted inconsistencies regarding Fox's testimony as it related to the testing of control objective S-4(x), his testimony was noteworthy for its lack of candor in other areas. Fox initially denied that the statutory reference to takeout rates was in PwC's work papers or that his staff looked at the statute to compare the law and the takeout rates listed in the configuration report. When confronted with the statute in the work papers during his interview, Fox claimed that the statute was in the work papers "because it was the law and somebody thought it would be good to have the law in the database," but continued

[77] By stating that the control belongs to NYRA, Fox was alleging, at least in part, that it was NYRA's responsibility to check the process, not United Tote. This assertion, however, is inconsistent with how the control works. Makovich told the Inspector General that he created the process of sending the configuration report and the race card to NYRA before the commencement of racing each day, that he demanded that NYRA return them signed by a pari-mutuel department manager, and that he retains the signed and approved reports once the process is complete.

to deny it was included for comparison purposes. Fox also offered that the statute was included in the work papers because someone, either the Experienced Associate or another unknown employee, "thought it might be helpful information." Fox finally conceded that he was unaware that the statute was even in the work papers during the engagement, but learned about it afterwards when the Racing and Wagering Board contacted him in January 2012 to obtain a copy of PwC's work papers for its investigation.

Fox also claimed that PwC's engagement letter with United Tote did not require that PwC look at the takeout rate. After agreeing that PwC's engagement letter contained control objectives copied verbatim from Racing and Wagering Board's totalisator audit standard control objectives, including control objective s-4(x) relating to commissions, Fox then asserted that the engagement letter was written that way to meet "NYRA's expectations" and that he made it clear to United Tote's then President Murr that "certain requirements outlined here (referring to the Totalisator SAS 70 report requirements from the Racing and Wagering Board) . . . are not feasible." When confronted with Fox's statement, Murr denied this claim and stated, "I assumed that they would validate the takeout rate" as part of the engagement. Fox alternately claimed that the Racing and Wagering Board requirements contained "suggestions" about the testing Racing and Wagering Board wished to see,[78] but stated that it was his decision which steps PwC would actually take.[79] Fox admitted, however, that he did not contact anyone at the Racing and

[78] Contrary to Fox's testimony, the Experienced Associate told the Inspector General that she was aware of the Racing and Wagering Board control objectives for the totalisator company stating, "We had specific New York State Racing and Wagering Board standards that we were looking at for reporting purposes." Her supervisor on the United Tote engagement, the Senior Associate, told the Inspector General that he received the control objectives from United Tote that were written by the Racing and Wagering Board and identified them as "requirements set by the board for what they want from the tote – from the tote audit report." Even Fox admitted that PwC received the tote standards; he just repeatedly claimed that they were not applicable to PwC's report.

[79] At another point in the interview, Fox stated that the Racing and Wagering Board could provide him with detailed guidance of what they wanted and he could comply. However, from both the Racing and Wagering Board's view, and frankly the Inspector General's opinion, that is exactly what Racing and Wagering Board had already done with its totalisator standards and Fox chose to copy the format and ignore the substance.

Wagering Board about its totalisator control objectives until after the takeout issue was discovered.

Ultimately, the Inspector General's inquiry determined that PwC's auditors attempted to test the takeout rate by inspecting the configuration report from a single day, September 15, 2011, an obviously deficient sample size. PwC then compared the configuration report to the correct statute but arrived at the wrong conclusion. The Inspector General cannot credit the testimony of PwC's engagement partner Jeffrey Fox based on the strength of the testimony of his subordinates to the contrary as well as the contents of PWC's work papers and reports.

L. The New York State Racing Franchise Accountability and Transparency Act of 2012

On June 16, 2012, the New York State Racing Franchise Accountability and Transparency Act of 2012 ("the Act") amended certain sections of the Racing Law, including section 207, which defines the structure of the NYRA Board. The stated purpose of the Act is to place NYRA under temporary public control for a period of three years "in order to reform the association and transform oversight and management of horse racing in New York State." Following the expiration of a maximum three-year period, it is the Legislature's intent to return the franchise to private control. However, before the franchise is restored, the Reorganization Board must propose a new governing structure to ensure the "viability and continuity of horse racing."[80]

Replacing the original 25-member board, the Act established a 17-member Reorganization Board:[81] eight directors appointed by the Governor, two directors appointed by

[80] Pursuant to the Racing Franchise Accountability and Transparency Act, the NYRA Reorganization Board must submit to the Governor and the State Legislature a statutory reorganization plan for NYRA no less than one hundred eighty days prior to the termination of the three-year period.

[81] In addition to the replacement of NYRA's Board of Directors, the Racing Franchise Accountability and Transparency Act prescribes that "each voting member of the Board of Directors of the franchised corporation shall

the Senate, two directors appointed by the Assembly, and five directors appointed by NYRA. In addition, the Reorganization Board has two ex-officio directors – one appointed by the New York Thoroughbred Breeders Inc., and one appointed by the New York Thoroughbred Horsemen's Association "to advise on critical economic and equine health concerns of the racing industry." The Reorganization Board became effective following the appointment of the majority of the publicly appointed members.

On October 18, 2012, Governor Cuomo announced the selection of his eight appointees to the NYRA Reorganization Board: David Skorton,[82] Bobby Flay, Jane Rosenthal, Leonard Riggio, Anthony Bonomo, Vincent Tese, Joseph Spinelli, and Robert Megna.[83] That same day, the Senate announced the appointment of Michael Dubb and Earle Mack, and the Assembly announced the appointment of Michael J. Del Guidice and Rick Cotton. Thereafter, NYRA announced its appointed directors: Steven Duncker, Barry Ostrager, Stuart S. Janney III, Stuart Subotnick and Charles Wait. Chester Broman was appointed ex officio for the New York Thoroughbred Breeders, and Richard A. Violette, Jr. was appointed ex officio for the New York Thoroughbred Horsemen's Association.

NYRA's directors are comprised solely of former members of the NYRA Board of Directors. Among NYRA's selections is former Chairman of the Board Duncker, who held the position of NYRA Chairman since 2000. As Chairman, Duncker was integrally involved in business decisions which affected NYRA, including decisions made during the 18-month period that NYRA overcharged its bettors the incorrect takeout rate – the subject of the instant

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annually make a written disclosure to the board of any interest held by the director, such director's spouse or unemancipated child, in any entity undertaking business in the racing or breeding industry."

[82] On December 12, 2012, Skorton was named Chairman of the Board.

[83] Governor Cuomo also named, John Hedrickson, Special Advisor for the Saratoga Region, a non-voting position. In addition, Dr. Michael Kotlikoff serves as Special Advisor to the NYRA Reorganization Board for Equine Health and Safety.

investigation. During that time, Duncker communicated with former NYRA President/CEO Charles Hayward weekly and communicated regularly with other NYRA executives including former General Counsel Patrick Kehoe. Moreover, Duncker was Chairman during the period when NYRA was the subject of many problems: the 2003 indictment by federal authorities for crimes including conspiracy to defraud the United States and aiding and abetting false tax returns; NYRA's filing for bankruptcy in 2005; and the filing of federal tax liens against NYRA in 2006.

M. Establishment of the New York State Gaming Commission

New York State recently enacted legislation that created a state Gaming Commission to, among other objectives, promote integrity and transparency in gaming. The Gaming Commission, which became effective on February 1, 2013,[84] supervises all areas of gaming in New York State. According to its legislative intent, the New York State Gaming Commission was designed to consolidate the state's gaming regulatory functions into a single oversight body so as to achieve strict state regulation of all corporations, associations and persons engaged in gaming activity. The merger was also intended to increase efficiency, reduce costs and eliminate unnecessary redundancies in regulation. Furthermore, the new entity's goals include conducting gaming of the "highest integrity, credibility and quality" and ensuring the exclusion of unsuitable persons or entities from participating in state gaming activities.

By statute, the Gaming Commission is comprised of seven members appointed by the Governor by and with the advice and consent of the Senate. Of the seven members, one is appointed upon the recommendation of the temporary president of the senate and one upon the

[84] Under Chapter 60 of the Laws of 2012 (signed by Governor Cuomo on March 30, 2012), the commission was to become effective on October 1, 2012. Chapter 457 of the Laws of 2012 (signed September 28, 2012) extended the effective date to February 1, 2013.

recommendation of the speaker of the assembly.[85] Governor Cuomo has designated Mark Gearan chair of the commission, and has also appointed four other members: John A. Crotty, John J. Poklemba, Barry Sample, and Todd R. Snyder. Commission members serve five-year terms and are compensated on a per diem basis.[86] Members are required to be residents of New York with five or more years of experience in public or business administration and involvement in one of the following: accounting, corporate finance and securities, gaming or racing regulatory administration or industry management, or criminal investigation, law enforcement or law.[87]

The Gaming Commission subsumed the former Division of Lottery and the Racing and Wagering Board and also has the power to appoint its own staff. The commission has established and supervises four divisions – The Division of Lottery,[88] Charitable Gaming,[89] Gaming,[90] and Horse Racing and Pari-Mutuel Wagering.[91] Each division is headed by a director and charged with the regulation and enforcement of their respective areas. The commission's powers and duties include general jurisdiction over all gaming activities within the state and over the corporations, associations and persons engaged therein; gaming licensing; gaming testing and surveillance; compliance monitoring and video lottery gaming facility operations, among others.

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[85] Racing, Pari-Mutuel Wagering and Breeding Law §102(1).
[86] Racing, Pari-Mutuel Wagering and Breeding Law §§ 102(3) and (4).
[87] Racing, Pari-Mutuel Wagering and Breeding Law § 102(2).
[88] Racing, Pari-Mutuel Wagering and Breeding Law §§ 103(a), 117 and 118. The Division of Lottery is responsible for the operation and administration of the State Lottery for education, as prescribed by Tax Law Article 34, excluding video lottery gaming. The Division of Lottery has transferred its functions, duties, obligations and employees to the commission.
[89] Racing, Pari-Mutuel Wagering and Breeding Law § 103(b). The Division of Charitable Gaming is responsible for the supervision and administration of the games of chance licensing law, bingo licensing law and bingo control law as prescribed by General Municipal Law Articles 9-A and 14-H and Executive Law Article 19-B.
[90] Racing, Pari-Mutuel Wagering and Breeding Law § 103(c). The Division of Gaming is responsible for the administration, regulation or oversight of Indian gaming as defined by tribal-state compacts in effect pursuant to the Indian Gaming Regulatory Act, 25 U.S.C. § 2701, et seq., and operation and administration of video lottery gaming, as prescribed by Tax Law Article 34.
[91] Racing, Pari-Mutuel Wagering and Breeding Law §§ 103(d), 117 and 118. The Division of Horse Racing and Pari-Mutuel Wagering is responsible for the supervision, regulation and administration of all horse racing and pari-mutuel wagering activities, as prescribed by Racing, Pari-Mutuel Wagering and Breeding Law Articles 2-11. The Racing and Wagering Board will transfer its functions, duties, obligations and employees to the commission.

The Gaming Commission maintains the right to examine the records of those engaged in regulated gaming activities; conduct investigations pertaining to violations, including obtaining testimony under oath and issuing subpoenas; and levy and collect civil penalties and fines for violations. Additionally, the commission may conduct background investigations on any regulated individual and access relevant records of the New York State Division of Criminal Justice Services. The commission collects regulatory fees from the entities it oversees.[92]

Commission members are held to ethical standards and barred from activities presenting a perceived or actual conflict of interest.[93] Among other prohibitions, its members and employees may not have a direct or indirect interest in, or employment by, any corporation, association or person engaged in gaming activity within the state. Commission members, officers, officials or employees may neither participate as horse owner or race contestant at a race within the jurisdiction of the commission, nor may they have any monetary interest in the purse, prize, or other race outcome. Moreover, commission members, officers and employees are prohibited from wagering upon state gaming or horse racing.[94]

[92] Racing, Pari-Mutuel Wagering and Breeding Law §104.
[93] On June 5, 2013, Governor Cuomo released the Upstate New York Gaming Economic Development Act, which, among other things, authorizes a state gaming inspector general to prevent corruption at the Gaming Commission.
[94] Racing, Pari-Mutuel Wagering and Breeding Law §§ 102(5) and 107.

IV. FINDINGS AND RECOMMENDATIONS

The New York State Inspector General conducted an investigation into a 15-month overcharge of an exotic wager takeout rate by the New York Racing Association, Inc. and found that every level of internal control and audit at NYRA failed to identify the incorrectly charged takeout rate. These failures occurred, in part, because of NYRA's inadequate policies and procedures and deficient audit plans. In addition, the New York State Racing and Wagering Board, whose duties included regulating horse racing, similarly did not detect the takeout overcharge – a failure resulting from a lack of any formal system to track and calendar expiration dates of statutes and to perform checks as to whether rates were in compliance with the law. Nevertheless, the Inspector General determined that primary responsibility rests with NYRA executive management who did not lower NYRA's exotic takeout rate as required after September 15, 2010, thereby causing NYRA to be out of compliance with the law until late December 2011. Moreover, the correction occurred only when the Office of the State Comptroller discovered the overcharge during a routine audit of a wholly separate entity.

In New York State, takeout rates for horse racing are dictated by statute. The track retains a certain percentage of the total amount of money wagered on a race depending on the type of bet – commonly referred to as takeout. In June 2008, legislation was enacted that, among other actions, changed the takeout rates NYRA could charge. The legislation created an effective one percent increase in the takeout rate of all wagers placed on races run on NYRA tracks, and, importantly, included a sunset provision that the increase would expire after two years, on September 15, 2010. The Legislature accordingly raised the floor on the range of most of NYRA's takeout rates to impose the one percent increase. With regard to the exotic takeout rate, however, NYRA was already employing a takeout rate at the top of the previously

permitted range of 15-25 percent. Therefore, in contrast to the other types of wagers, the Legislature imposed a fixed rate of 26 percent for exotic bets. The Inspector General determined that NYRA failed to identify this fixed rate and to calendar the sunset date to ensure compliance with the statute.

First and foremost, NYRA's law department failed to ensure that NYRA was complying with the statutorily mandated takeout rates for its wagers. Former General Counsel Patrick Kehoe did not make a written notation of this sunset date in his work calendar, nor did anyone else in the law department. William Crowell, NYRA's former legislative counsel and lobbyist, similarly testified that he did not calendar the sunset date of the increase in takeout rates. More significantly, however, even if they had calendared the date, the investigation revealed that NYRA did not appreciate or take note of the implications of the sunset provision related to the fixed 26 percent takeout set for exotic wagers, at least at the time the sunset provision was triggered and, in some instances, never. Specifically, when the statute expired and the takeout rates reverted to the pre-June 2008 rates, NYRA was operating under the misimpression that the takeout rates *could* be lowered, and not that the exotic takeout rate *must* be lowered to ensure compliance with the law. Former NYRA President and Chief Executive Officer Charles Hayward testified to operating under this misunderstanding of the law as well.

Aside from an inexcusable inattention to the details of the newly enacted 2008 legislation by Kehoe, NYRA Assistant General Counsel Pasquale Viscusi also failed to monitor the new takeout legislation. In August 2008, Viscusi responded to an inquiry from the NYRA simulcasting department regarding this newly enacted legislation that raised NYRA's takeout rates one percent. Notably, Viscusi provided the department a detailed analysis of the legislation that indicated his understanding of the fixed takeout rate of 26 percent for exotic wagers, but

when testifying before the Inspector General in 2012, Viscusi denied knowledge of the fixed rate. Regardless, Viscusi, who also held the title of NYRA Regulatory Compliance Officer, did not deem the sunset of the takeout legislation to be within his purview so as to calendar it or memorialize it in any way.

In addition to failing to calendar the sunset date and to accurately note the fixed takeout rate for exotic wagers, NYRA's law department missed other opportunities to prevent this substantial error, as demonstrated by, among other evidence, emails in late September 2010 and October 2010 in which Kehoe discussed the sunset of the takeout law with Crowell and Hayward. These emails reveal that Kehoe had ample opportunity to uncover NYRA's exotic wager takeout overcharge but simply failed to do so. In addition, as NYRA's then legislative counsel, Crowell should have reviewed the statute relating to NYRA, his longtime client, and inquired if any legislative or remedial action was required. Instead, he simply sent Kehoe the requested legislation and did nothing else.

NYRA missed another opportunity to identify and rectify this problem in August 2011, when Steven Crist, Hayward's longtime friend and the publisher and a columnist of the *Daily Racing Form*, contacted Hayward asking for a comment regarding a question posed by one of his readers. Crist forwarded Hayward the reader's email inquiry, which asked when NYRA would lower the takeout rates and correctly stated that the takeout rate for the exotic wagers was "currently outside the parameters of the law." The reader also noted that if NYRA wanted to lower takeout, all it had to do was request to do so from the Racing and Wagering Board. Hayward responded to Crist that this reader was in fact correct and proceeded to posit reasons why he believed NYRA's takeout rates could not be lowered at that time. When asked about this email exchange, Hayward questionably testified that he only had focused on the portion of the

email stating that NYRA could request a takeout reduction from the Racing and Wagering Board and had failed to read the email in its entirety. Regardless of the veracity of this representation, Hayward was, at best, careless in his reading of this email. More significantly, Hayward was derelict in his duties in failing to take note of NYRA's noncompliance with the statutory takeout rate for exotic wagers – a fact plainly stated in the email.

Other departments at NYRA also failed to calendar and note the fixed takeout rate for exotic wagers. In late 2009, the finance department, headed by then Chief Financial Officer Ellen McClain, prepared a 2010 budget projection for NYRA's Board that explicitly included mention of the September 15, 2010 sunset date for the one percent increase in NYRA's takeout rates. McClain testified to the Inspector General that she did not recall the sentence in the budget projection regarding the sunset of the takeout provision but conceded that it was likely that she discussed it with the preparer of the report. She further claimed that she would not deem a late-year reduction in takeout of one type of wager to be material to the budget. In contrast, however, the member of the finance department responsible for calculating takeout projections for NYRA disagreed with McClain's assessment as to materiality of this oversight, given the revenue at stake. The finance department and McClain should have been better focused on the takeout legislation because takeout is NYRA's major source of revenue.

NYRA's simulcasting department also routinely deals with takeout rates and also missed an opportunity to identify NYRA's noncompliance with the exotic wager takeout rate. Simulcasting is the transmission of live races to various sites for the purpose of pari-mutuel betting. Takeout rates affect simulcasting contracts because the simulcasting sites, with certain exceptions, must charge the same takeout rate for NYRA races they are simulcasting as NYRA charges for on-track wagering. As such, part of every simulcast contract includes a list of the

takeout rates then in effect. When the Legislature imposed on NYRA the one percent increase in takeout rates, NYRA's simulcasting department renegotiated with most of its simulcast sites to split the one percent increase. The simulcasting contracts even note the September 2010 sunset date. While the preponderance of the blame regarding the takeout debacle that occurred at NYRA rests with the law department, and specifically Kehoe, it is clear that others at NYRA were provided the law and neglected to read and analyze its details.

Former NYRA Board members also exhibited a limited focus on the legislation, the fixed takeout rate for exotic wagers, and the sunset date in varied testimony, either failing to specifically recall the one percent increase and sunset provision; denying knowledge of the sunset provision; denying awareness of the 26 percent fixed rate for exotic wagers; or denying awareness of the 2008 legislation at all. Given the importance of the 2008 legislation and the increase to NYRA's takeout rates, more attention should have been paid to the legislation particularly as it pertained to takeout rates, the lifeblood of NYRA's finances, at least enough to have inquired of Hayward and Kehoe of its status around the time of the sunset date of September 15, 2010.

The Audit Committee of NYRA's Board at the time also failed in its duties. According to its Charter then in effect, the Audit Committee was required to meet at least annually with NYRA's counsel to review "any legal matters that could have a significant impact on the organization's financial statements [and] NYRA's compliance with applicable laws and regulations." The Audit Committee also supervised NYRA's internal audit department. James Heffernan was the chair of the Audit Committee from October 2008 to the end of 2010. When asked what he thought should have been done by NYRA's internal audit department regarding the takeout rate, Heffernan stated that the internal audit department should have been contacting

the law department "on a regular basis" to determine whether it had "reviewed the statute that went through all the takeout rates and signed off on it." It was the Audit Committee chaired by Heffernan, however, that was tasked with meeting with counsel and failed to do so, and the Audit Committee that repeatedly approved the audit plans each year from 2008 to 2011, yet failed to require any such review of takeout rates.

According to the 2008 Charter of NYRA's internal audit department, its mission was to provide the Board of Directors and the Audit Committee with "reasonable assurance" that "NYRA's established policies and procedures are adequate, are being adhered to, and that these policies and procedures enable NYRA to achieve its goals." The Director of Internal Audit was required to establish a yearly audit plan which must be approved by the Audit Committee. The internal audit department was specifically directed to include in its audit scope the integrity of internal controls relating to operating and financial information as well as statutory and regulatory compliance. The Inspector General determined, however, that until the takeout issue was exposed in December 2011, no one in NYRA's internal audit department even reviewed the takeout rates, let alone conducted any audit to assess their accuracy.

Not only did the internal audit department fail to review the takeout rate, it similarly failed to review the internal controls of the law department whose duties specifically included statutory compliance. One former internal auditor affirmatively stated that NYRA had no controls in place to ensure that the correct takeout rates were being charged. In fact, no one at NYRA audited or reviewed the issue of statutory compliance until after the takeout issue was reported to NYRA by the Racing and Wagering Board, and then only in response to a demand in 2012 by its external auditor, UHY, LLP that it do so. If the internal audit department had reviewed the law department's internal controls, it would have found, as the Inspector General

did, that no system was in place to periodically check compliance with statutory rates or to properly calendar important legislative dates like the sunset provision relating to takeout rates.

In addition, after the death of the Director of Internal Audit in June 2011, NYRA did not appoint a new Director of Internal Audit. Instead, the management of the internal audit department was assumed by then CFO McClain. This structure was contrary to the Audit Committee Charter and the standards of the Institute of Internal Auditors which requires internal audit to be structurally independent from management. McClain's involvement in internal audit department functions was pervasive: she became involved in the performance reviews of internal audit department staff and dismissed at least one employee, which left a staff of two; she reviewed Audit Committee minutes before they were provided to committee members; she oversaw the search for an outside company to perform the internal audit function in the wake of the director's death; and she directed the activities of Deloitte & Touche, LLP, once they were retained, to re-vamp the internal audit department, and then required that the subordinate staff report to an on-site Deloitte employee. These actions were all inappropriate given the mandate of the internal audit department.

With regard to an external auditor, pursuant to the Racing Law, NYRA is required to retain a certified public accountant to audit NYRA's year-end financial statements and to render an opinion regarding the efficacy of NYRA's system of internal controls. From 2005 until the end of the audit work that includes calendar year 2011, UHY was retained as the external auditor for NYRA. Although UHY performed compliance audits, financial audits, and tax work for NYRA, it failed to uncover that NYRA was out of compliance with the statutory takeout rate at issue as well as tax rates and breeders' fund contributions, because it relied solely on NYRA for information as to the correct statutory takeout rates when other options were readily available – a

practice contrary to standard accounting principles. The Inspector General determined that UHY's compliance audits failed to achieve their stated objectives. The Inspector General further determined that, with regard to the yearly audit of NYRA's financial statements, UHY failed to engage in an audit sufficient to test the accuracy of NYRA's revenue and statutory payment calculations which underlie its financial statements.

NYRA employs a totalisator company to electronically combine its bets into pools and calculate odds and projected payoffs. For the period relevant to this investigation, NYRA contracted with United Tote for totalisator services. The Inspector General found no wrongdoing with United Tote. However, the Inspector General found fault with United Tote's external auditors. Berry Dunn McNeil and Parker (Berry Dunn) was United Tote's external auditor until late 2010. Regarding whether the takeout rates were properly set in the configuration report, Berry Dunn admitted that it did nothing to test whether the takeout rates conformed to New York statutory requirements. While Berry Dunn's testing examined whether required reports, including configuration reports, were generated for NYRA by United Tote, it did not examine whether the takeout rates in those reports were set "in accordance with NY requirements" as it claimed in its October 2010 report. Berry Dunn admitted to the Inspector General that it did not verify that the takeout rates programmed in United Tote's system conformed to New York State statutory requirements.

In 2010, United Tote's parent company merged into Churchill Downs, Inc. For the report ending September 30, 2010, United Tote permitted Berry Dunn to complete the review that had already commenced. After that report, United Tote engaged PricewaterhouseCoopers (PwC), Churchill Downs' auditors, to perform the totalisator audit. Based on the interviews of PwC's two on-site auditors, the Inspector General determined that PwC failed to conduct a thorough

review of the takeout rates. While the auditors accessed the correct statute with the correct rates, their analysis was inadequate to uncover the takeout rate error. Despite the fact that United Tote retained "file drawers full of the returns," the PwC partner in charge did not look at the returned configuration reports because he unilaterally decided that the control belonged to NYRA, not United Tote. When confronted with this statement, United Tote's president denied this claim and stated, "I assumed that they would validate the takeout rate" as part of the engagement. Based on the interviews of PwC's two on-site auditors, the Inspector General determined that PwC failed to conduct a thorough review of the takeout rates.

The Racing and Wagering Board similarly failed to identify NYRA's takeout overcharge and to monitor the expiration of the takeout legislation. While the evidence indicates that the Racing and Wagering Board's legal department read and analyzed the statute, former Racing and Wagering Board Counsel Robert Feuerstein conceded that he did not calendar the sunset date and that he was primarily "responsible for legislative matters and these types of things." As a result, no one at the Racing and Wagering Board realized when the legislation expired. The Inspector General determined that when the takeout rate reverted, the Racing and Wagering Board did not have a process in place to periodically or even annually compare the statutory takeout rate to the rate in effect.

In 2012, New York State enacted legislation that created the New York State Gaming Commission to, among other objectives, promote integrity and transparency in gaming. The Gaming Commission, which became effective on February 1, 2013, supervises all areas of gaming in New York State. According to its legislative intent, the Gaming Commission was designed to consolidate the state's gaming regulatory functions into a single oversight body so as to achieve strict state regulation of all corporations, associations and persons engaged in gaming

activity. The merger was also intended to increase efficiency, reduce costs and eliminate unnecessary redundancies in regulation. The new entity's goals include conducting gaming of the "highest integrity, credibility and quality" and ensuring the exclusion of unsuitable persons or entities from participating in state gaming activities. In addition, on July 30, 2013, Governor Cuomo signed into law the Upstate New York Gaming Economic Development Act, which, among other mandates, authorizes a state gaming inspector general to prevent corruption at the Gaming Commission.

Recommendations

The Inspector General recommends the following remedial measures:

NYRA's law department should establish a system to track the expiration dates of pertinent legislation and other significant dates. Routine checks of the takeout rates and other statutorily mandated rates should be performed regularly. To that end, detailed written controls must be established to inform the actions of the law department. Specifically, the Regulatory Compliance Officer must be tasked with developing and implementing a plan to ensure compliance with the extensive statutory mandates that govern NYRA.

Given that NYRA's finance department budgets NYRA's revenue which is directly related to NYRA's takeout, it must be aware at all times of the statutes that dictate those rates. Accordingly, the Inspector General recommends that the finance department maintain a list of takeout rates, the corresponding statutes and any sunset dates, and confer with the law department on a regular basis to ensure that no changes in the law have occurred. In addition, because simulcasting contracts list the takeout rates the simulcasting sites may charge, the simulcasting department must create formal policy and procedure to ensure that the correct takeout rates are being utilized in its contracts. Like the finance department, the simulcasting

department must maintain a list of takeout rates, the corresponding statutes and any sunset dates, and confer with the law department on a regular basis to ensure that no changes in the law have occurred.

NYRA's internal audit department should establish audit plans that include scheduled audits of every department at NYRA. Specifically, given the significant statutory prescriptions mandated for NYRA and their effect on NYRA's finances and revenue, annual or bi-annual audits of the law and finance departments should be conducted. Furthermore, NYRA should take steps to ensure that the internal audit department operates and exercises judgment independent of NYRA executive staff and functions solely at the direction of the Audit Committee.

The NYRA Reorganization Board must ensure that the Audit Committee, tasked with ensuring the integrity of the NYRA's financial reporting process and systems of internal controls regarding finance, accounting, operations and legal compliance, engages in a robust review of both the internal and external auditors. The Audit Committee, charged with pre-approving the audit plans of NYRA's internal auditors, should confirm that the audit plans include regular contact with the law department to ensure that the law department has a plan to review – and has in fact reviewed – the statutes delineating the required takeout rates and other statues that impact NYRA.

The Audit Committee should require the external auditor to identify deviations from generally accepted accounting principles and identify those internal controls which are ineffective. Specifically, the Audit Committee should ensure that the external auditor inquires of independent third parties in its verification process rather than relying on NYRA for information as to the correct statutory takeout rates and other rates and taxes.

NYRA's contract with its totalisator company requires that it provide NYRA with a yearly audit of its tote services.[95] As such, NYRA should include in the terms of that contract that the totalisator's independent auditor take steps to test whether the takeout rates employed by NYRA and all other statutory contributions and tax rates calculated by the totalisator company from NYRA's daily handle conform to New York statutory requirements.

As a result of the takeout issue discussed in this report, the Racing and Wagering Board announced a plan[96] to institute the following remedial measures:

- The Board will include in its annual report a summary of statutes or provisions that have expired or reverted;
- The Board will annually review the qualifications of the auditors performing . . . audits;
- The Board will require all racetracks to submit takeout configuration reports on a periodic basis and the Board will verify the takeouts with the Racing Law;
- The Board will require racetracks to publish their takeout rates with a web link to the current statutory takeout sections of the law.

The Inspector General concurs with the Racing and Wagering Board's proposals.

Since the issuance of those proposals, New York State enacted legislation to create the New York State Gaming Commission. The Gaming Commission has adopted the measures proposed by the Racing and Wagering Board, but it should determine if further measures are necessary within the new structure of the Gaming Commission.

[95] An audit also is required by Racing, Pari-Mutuel Wagering and Breeding Law § 240.
[96] The plan was announced in the Racing and Wagering Board's April 26, 2012 Interim Report.

V. RESPONSE FROM NYRA

NYRA agreed with the Inspector General's findings and recommendations. Chairman Skorton noted: "We believe our new policies, procedures and governance meet the specific recommendations set forth in the Inspector General's report. But beyond the internal controls and new procedures, our new Board of Directors and senior management team share a combined commitment to greater transparency, compliance and accountability that was not demonstrated in the past."

Skorton elaborated that NYRA has demonstrated a commitment to "greater transparency with the government and the public." Skorton noted NYRA's cooperation with the Inspector General's investigation, the Reorganization Board's waiver of privilege as to the business integrity counsel, and the webcasting to the public of the Reorganization Board's meetings.

Skorton then explained NYRA's commitment to better management and control policies. The law department now maintains a comprehensive chart that tracks the dates and summarizes changes in legislation, regulations and case law. NYRA has also retained the law firm of Greenberg Traurig, LLP, to provide a monthly review of statutes, and a daily review during legislative sessions. The firm also reviews the law department's chart bimonthly to confirm its accuracy. The law department also conducts a quarterly review of takeout rates and other rates during NYRA's "Quarterly Rate Review." During this review, the finance department also confirms NYRA's actual relevant cash flows. These departments also confer with the simulcasting department to ensure that the simulcasting contracts reflect the correct rates. All simulcasting contracts are reviewed by the law department. The law and finance departments also confer with the pari-mutuel department to ensure that the correct takeout rates are being charged.

Finally, Skorton reported that the Reorganization Board has a newly titled "Audit and Compliance Committee," which "has developed a comprehensive but tightly focused approach to risk mitigation and fiduciary control." Former New York State Inspector General Joseph Spinelli was chosen to head this committee. The committee has created a new charter which calls for it "to oversee compliance 'with all applicable statutes, rules and regulations pertaining to the conduct of Thoroughbred horse racing and the oversight thereof by the New York State Franchise Oversight Board and the New York State Gaming Commission.'" This committee also oversees the law department and business integrity counsel. The committee, working with NYRA's CFO, has instituted new internal audit policies, procedures and controls. NYRA retained Deloitte & Touche "to review all key processes identified through a company risk assessment." This project was completed in May 2013. The head of Internal Audit now reports directly to the chair of the Audit and Compliance Committee, and internal audit reports are reviewed by the committee. Finally, in August 2012, NYRA selected KPMG, LLP as its auditor.