STATE OF CALIFORNIA

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COMMISSION ON CALIFORNIA STATE GOVERNMENT ORGANIZATION AND ECONOMY

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Executive Director

A REVIEW OF THE ORGANIZATION, OPERATION AND PERFORMANCE OF THE CALIFORNIA STATE LOTTERY

JANUARY 1987

A REVIEW OF THE ORGANIZATION, OPERATION AND PERFORMANCE OF THE CALIFORNIA STATE LOTTERY

A Report of the
COMMISSION ON CALIFORNIA STATE GOVERNMENT
ORGANIZATION AND ECONOMY

January 1987

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, *Governor*

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1127 - 11th Street, Suite 550, (916) 445-2125
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January 20, 1987

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Executive Director

The Honorable George Deukmejian
Governor of California

The Honorable David A. Roberti
President pro Tempore of the Senate
and Members of the Senate

The Honorable James Nielsen
Senate Minority Floor Leader

The Honorable Willie L. Brown, Jr.
Speaker of the Assembly
and Members of the Assembly

The Honorable Patrick Nolan
Assembly Minority Floor Leader

Dear Governor and Members of the Legislature:

In August 1986, our Commission initiated a study of the organization, operation, and performance of the California State Lottery (Lottery). The Commission undertook this study because the Lottery was rapidly developing into a large state agency with an authorized staff of more than 1000 positions and an annual administrative operating budget of approximately $70 million. Moreover, the Lottery was administering a statewide business operation with revenues approaching $2 billion per year.

The Commission concluded that the Lottery has accomplished a great deal in a relatively short time and should be commended for the hard work of its staff. However, the Commission also found that the Lottery's rapid growth and meteoric sales have placed tremendous demands on the Lottery's staff in conducting its business operations. As a result, the Lottery has failed to establish certain business systems and controls necessary in an enterprise of its size. Moreover, in the absence of such controls, there is not full assurance that the Lottery is operating efficiently and that funding for education is being maximized.

The "bottom line" in the Lottery's operations is that every dollar saved in administrative costs is an additional dollar that can be used in California's classrooms. Our study identified specific concerns that need to be addressed by the Lottery to ensure that it minimizes administrative costs and maximizes educational funding. Our Commission's findings include the following:

- The Lottery has relied too heavily on sole-source contracts to purchase goods and services. Approximately 71 percent of the contracts over $10,000 that the Lottery entered into during the past two fiscal years were sole-source contracts.

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- The Lottery does not have a system in place to identify and recover unclaimed low-tier prizes paid by lottery ticket retailers. As a result, an estimated $13.8 million to $34.6 million in funds have been lost to the State's educational system during the Lottery's first nine instant ticket games.

- The Lottery has not established an adequate contract management system to monitor contract performance and payments. As a result, the Lottery has exceeded allowable contract payment limits in some instances and received goods and services without a valid contract in effect that has been approved by the California State Lottery Commission.

- Scientific Games, Inc. and its parent company, Bally Manufactoring, Inc., apparently have made conflicting statements in oral and written testimony to the Legislature and the Little Hoover Commission regarding business involvement in South Africa.

- The minority business enterprise contract that Scientific Games, Inc. has with Security Packaging, Inc. raises questions regarding the actual management and control of Security Packaging, Inc.'s operations.

- The Lottery does not have an independent review and appeals process in place to review vendor bid protests. As a result, the current bid protest process lacks the appearance of independence and its objectivity has been questioned.

- The Lottery has not provided timely or complete monthly financial reports required by law as a means to provide public accountability for the Lottery's activities.

- The Lottery is exempt from an independent budget review by the Legislature. As a result, the Legislature does not have the same level of assurance that the Lottery is operating in an economical manner as the Legislature has with other State agencies.

- The Requests for Proposals that the Lottery has developed for the procurement of goods and services have not been as specific and detailed as necessary in some instances.

The Commission also found that the Lottery has unprecedented flexibility as a state agency in how it conducts its business operations due to the provisions of the Government Code established by Proposition 37. Generally speaking, the Lottery is exempt from most normal state government controls and oversight that are used in other state agencies. Although the Lottery has more latitude in conducting its business operations, the Little Hoover Commission believes that the Lottery has an ethical obligation to meet or exceed

the State's operating guidelines so that the Lottery's integrity is above reproach.

To further improve the organization, operation, and performance of the Lottery, the Little Hoover Commission has made 12 recommendations in this report. These include:

1. The Governor and the Legislature should require the Lottery to utilize competitive bidding for purchases of goods and services of $10,000 or more.

2. The Governor and the Legislature should require the Lottery to determine if goods and services are available through the Department of General Services' existing contracts or state price schedules prior to undertaking any procurement of $10,000 or more.

3. The Governor and the Legislature should require the Lottery to establish a centrally administered contracts management system.

4. The Lottery should develop, adopt, use, and maintain consistent and comprehensive contracting procedures.

5. The Governor and the Legislature should require the Lottery to follow the guidelines in the State Administrative Manual in preparing Requests for Proposals.

6. The Lottery should clarify and improve its Request for Proposal development and proposal evaluation processes.

7. The Governor and the Legislature should require the Lottery to use an independent review and appeals process to resolve contract disputes.

8. The Lottery Commission should review the minority business enterprise subcontract of the current instant game ticket contractor.

9. The Lottery Commission should review Scientific Games, Inc.'s business involvement in South Africa and the declarations that Scientific Games, Inc. made regarding its business involvement in South Africa to the Legislature.

10. The Governor and the Legislature should require the Lottery to contract for an independent study to determine the amount of unclaimed low-tier prizes. They also should require the Lottery Commission to determine if it is economically feasible and practical to develop a system to recapture lost revenues from unclaimed low-tier prizes.

11. The Governor and the Legislature should require the Lottery to provide more timely and complete financial reports.

12. The Governor and the Legislature should require that all Lottery funds be subject to legislative review through the State's normal budget process.

The Commission believes that these actions are necessary to improve the business systems and operations of the Lottery. Moreover, they will maintain the integrity of the Lottery and will serve to ensure that the Lottery achieves its goal of providing the most revenue it can for the State's educational system.

Respectfully submitted,

NATHAN SHAPELL, Chairman
James Bouskos, Vice Chairman
Senator Alfred Alquist
Mary Anne Chalker
Albert Gersten, Jr.
Haig Mardikian
Senator Milton Marks
Assemblywoman Gwen Moore
M. Lester Oshea
Abraham Spiegel
Richard Terzian
Jean Kindy Walker
Assemblyman Phillip Wyman

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EXECUTIVE SUMMARY

The Commission on California State Government Organization and Economy, also known as the Little Hoover Commission, initiated a study of the organization, operation, and performance of the California State Lottery (Lottery) in August 1986.

The Lottery has made significant accomplishments in its first year of operations, including generating approximately $2 billion in lottery revenues and establishing the Lottery's business operations throughout the State. Moreover, the Lottery is now the State's 24th largest department with an authorized staff of more than 1,000 positions and an administrative operating budget of approximately $70 million per year. However, the Lottery's dramatic growth has placed tremendous demands on its business operations.

The review of the Lottery's activities showed that the Lottery's staff have worked hard to design, establish, and carry out the Lottery's operations. However, the study revealed that the Lottery now needs to take action to fully implement the business systems, procedures and controls that are expected in an enterprise of its magnitude. Specifically, the study identified three major areas that the Lottery needs to address. The study showed that the Lottery needs to make major improvements in the management and operation of its procurement function. It also revealed that the Lottery needs to closely examine its relationship with certain contractors to determine if existing contractual requirements are being adherred to by the contractors.

Finally, the study identified improvements that need to be made in the Lottery's financial accountability and controls.

The Little Hoover Commission's report presents a total of nine findings in the three main chapters of the report. The findings in each of these chapters are referenced and briefly summarized below.

CHAPTER II - THE LOTTERY NEEDS TO IMPROVE ITS PROCUREMENT PROCEDURES AND PRACTICES

Finding #1 - The Lottery Has Relied Too Heavily on the Use of Sole-Source Contracts to Purchase Goods and Services

Since the Lottery began its business activities in early 1985, it has relied extensively on sole-source contracts to purchase goods and services. For example, our review showed that approximately 71 percent of the contracts for goods and services over $10,000 that the Lottery entered into in the past two fiscal years were sole-source contracts. While this practice may have been justified initially because the Lottery needed to acquire equipment, materials and services and become operational in an extremely short time frame, the Lottery now needs to make greater utilization of the competitive bid process for future contracts to ensure that it procures goods and services at the lowest available cost. This also will ensure that all responsible vendors have an opportunity to bid on potential Lottery contracts.

Finding #2 - The Lottery's Contract Management System Does Not Provide Adequate Controls

The review of the Lottery's current contract management system revealed that certain contracts are not being monitored or tracked, some contract files do not contain sufficient information to monitor performance, and current procedures are inadequate to ensure proper control of contract performance and payments. As a result, in some instances the Lottery has exceeded allowable contract payment limits and received goods or services without valid contracts in effect. Moreover, this undermines the Lottery Commission's ability to exercise control over the Lottery's expenditures.

Finding #3 - The Lottery Needs to Clarify and Improve its Request for Proposal Development and Proposal Evaluation Processes

The Lottery has received considerable criticism from prospective vendors regarding the process it uses to develop Requests for Proposals (RFPs) for the procurement of goods and services and the process it uses to evaluate proposals it receives. The review of these concerns indicated that the Lottery needs to work to further improve its RFP preparation and proposal evaluation processes so that vendors have a better understanding of what the Lottery seeks to procure and how the Lottery intends to evaluate proposals. For example, the review of the RFP for the most recent instant game ticket contract showed that the Lottery did not adequately define the services it wanted, the bid bond or letter of credit requirements, and the scoring methodology to be used in evaluating proposals.

Finding #4 - The Lottery Does Not Use an Independent Review and Appeals Process to Resolve Contract Disputes

Although the Lottery is required by statute to use a formal bid protest procedure for certain types of contracts, the Lottery's current bid protest procedure is administered by the Lottery Director. Since the Lottery Director is also directly involved in making initial procurement decisions, the Lottery's current bid protest procedure does not have the appearance of independence and its objectivity can and has been questioned. Moreover, the process that the Lottery uses to review bid protests and appeals differs considerably from and contradicts the independent review and appeals process used by other state departments.

CHAPTER III - THE LOTTERY NEEDS TO FURTHER REVIEW ITS EXISTING RELATIONSHIP WITH CERTAIN CONTRACTORS

Finding #5 - The Lottery Needs to Further Review the Minority Business Enterprise Subcontract Relationship of the Current Instant Game Ticket Contractor

The vendors that competed for the Lottery's recent multiple-game instant ticket contract have raised concerns regarding the validity of the subcontracting relationship between Scientific Games, Inc., the Lottery's current instant game ticket contractor, and its minority

subcontractor, Security Packaging, Inc. The review of these concerns indicated that there are several questions relating to the management and control of Security Packaging, Inc. and its relationship to Scientific Games, Inc. that need to be more fully investigated by the Lottery's Contract Compliance Office. Specifically, there are questions regarding the employment status of current employees of Security Packaging, Inc. that formerly worked for Scientific Games, Inc. and the degree to which Scientific Games, Inc. controls the operations of Security Packaging, Inc.

Finding #6 - The Lottery Commission Needs to Review the Statements Made By the Current Instant Game Ticket Contractor Regarding its Business Involvement in South Africa

The vendors that competed for the multiple-game instant ticket contract raised concerns regarding whether Scientific Games, Inc., the Lottery's current instant game ticket contractor, or its parent company, Bally Manufacturing, Inc., had business relationships in South Africa. Although two of the three losing vendors competing for the multiple-game instant ticket contract testified before the Little Hoover Commission that they also had business relationships with South Africa, the losing vendors questioned whether Scientific Games, Inc. made misrepresentations regarding its business relationships in South Africa in testimony before the Legislature in an effort to secure a contract with the Lottery. Under California law it is not illegal to do business in South Africa; however, the State recently passed legislation to divest its investments in South Africa.

The review of the statements made by Scientific Games, Inc. to the Legislature and to the Little Hoover Commission in oral and written testimony apparently contradict. For example, Scientific Games, Inc. testified to the Little Hoover Commission that neither it nor its parent company, Bally Manufactoring, Inc., had business relationships in South Africa. However, written documentation submitted by Bally to the Legislature states that from 1983 to 1986 it sold slot machines adapted for South Africa coins to a distributor, David Mercer International, which were destined for South Africa. Thus, there is a question if misrepresentations did occur before the Legislature and the Lottery Commission should determine if any actions are warranted with respect to Scientific Games, Inc.'s current Lottery contract.

CHAPTER IV - THE LOTTERY NEEDS TO IMPROVE ITS FINANCIAL ACCOUNTABILITY AND CONTROL

Finding #7 - The Lottery Does Not Have a System to Identify and Recover Unclaimed Low-Tier Prizes

The California State Lottery Act requires that unclaimed lottery prize money reverts for use to the State's educational system. Presently, the Lottery does not recover unclaimed low-tier prizes from Lottery ticket retailers, nor is the Lottery aware of how much money is being kept by retailers. While no accurate data is available on the extent of unclaimed low-tier prizes, estimates indicate that the Lottery's failure to recover unclaimed low-tier prizes may have resulted in a $13.8 million to $34.6 million loss in funds to the State's educational system during the Lottery's first nine instant ticket games.

Finding #8 - The Lottery Has Not Made Timely or Complete Financial Reports Required By Law

The monthly and quarterly financial reports that the Lottery is required by the Government Code to prepare are one of the primary means established to provide public accountability for the Lottery's activities. During its first year of operation, the Lottery has not provided timely and complete monthly financial reports. This has hindered the ability of State oversight agencies and policy makers to monitor the Lottery's performance and accountability.

Finding #9 - The Lottery is Exempt from an Independent Annual Budgetary Review

Unlike most other state agencies, the Lottery is exempt from normal budgetary review by the Legislature and other state oversight agencies. Because the Lottery's expenditures are not reviewed in the State's budgetary process, the Legislature does not have the same level of assurance that it has for other state department's operations that the Lottery is conducting its operations in a most economical manner. In addition, there is not full assurance that the amount of funding being generated by the Lottery for education is being maximized.

* * * * * * *

The Commission recommends that 12 specific actions be taken to further improve the business systems and operations of the Lottery. These include:

1. The Governor and the Legislature should require the Lottery to utilize competitive bidding for purchases of goods and services of $10,000 or more.

2. The Governor and the Legislature should require the Lottery to determine if goods and services are available through the Department of General Services' existing contracts or state price schedules prior to undertaking any procurement of $10,000 or more.

3. The Governor and the Legislature should require the Lottery to establish a centrally administered contracts management system.

4. The Lottery should develop, adopt, use, and maintain consistent and comprehensive contracting procedures.

5. The Governor and the Legislature should require the Lottery to follow the guidelines in the State Administrative Manual in preparing Requests for Proposals.

6. The Lottery should clarify and improve its Request for Proposal development and proposal evaluation processes.

7. The Governor and the Legislature should require the Lottery to use an independent review and appeals process to resolve contract disputes.

8. The Lottery Commission should review the minority business enterprise subcontract of the current instant game ticket contractor.

9. The Lottery Commission should review Scientific Games, Inc.'s business involvement in South Africa and the statements that Scientific Games, Inc. made regarding its business involvement in South Africa to the Legislature.

10. The Governor and the Legislature should require the Lottery to contract for an independent study to determine of the amount of unclaimed low-tier prizes. They also should require the Lottery Commission to determine if it is economically feasible and practical to develop a system to recapture lost revenues from unclaimed low-tier prizes.

11. The Governor and the Legislature should require the Lottery to provide more timely and complete financial reports.

12. The Governor and the Legislature should require that all Lottery funds be subject to legislative review through the State's normal budget process.

I. INTRODUCTION

The Commission on California State Government Organization and Economy, also known as the Little Hoover Commission (Commission), was established in 1962 to review the activities of the Executive Branch of California State Government and make recommendations to the Governor and the Legislature regarding how the State could conduct its business operations more efficiently and effectively.

The California State Lottery (Lottery) began selling lottery tickets on October 5, 1985. In its first year of operation, the Lottery experienced dramatic sales that far exceeded initial expectations. The Lottery is now a $2 billion-a-year business operation that employs more than 1,000 people and is the State's 24th largest department.

While the Little Hoover Commission recognizes that the Lottery has had considerable success selling tickets in its first year of operation, the Commission is concerned with the tremendous demands that the Lottery's meteoric sales have placed on the Lottery's staff in conducting business operations. Moreover, the Commission wants to ensure that the Lottery was putting in place the business systems and procedures necessary to establish adequate financial accountability and control.

The Commission initiated a study in August 1986 to address its concerns regarding the Lottery. As part of the study, the Commission held a public hearing on the organization, operation, and performance of the Lottery on October 29, 1986, at which time it received testimony from the Lottery and various State control agencies. In addition, the Commission held a follow-up public hearing on November 19, 1986 to receive testimony from private vendors regarding the Lottery's competitive bidding policies, procedures, and practices.

BACKGROUND

The California State Lottery was established with the passage of Proposition 37 in November 1984. The expressed purpose of the Lottery is "support for the preservation of the rights, liberties, and welfare of the people of California" by providing additional monies to benefit education without the imposition of additional or increased taxes.

Proposition 37 established a five-member, part-time California State Lottery Commission with broad powers to oversee the operations of the Lottery. The members of the California State Lottery Commission, along with the Director of the Lottery, are appointed by the Governor and are confirmed by the California State Senate. The Governor appointed the members of the California State Lottery Commission in January 1985 and the Director of the Lottery in March 1985. The Lottery began the sale of instant game tickets on October 5, 1985 and initiated an on-line "LOTTO" game on October 14, 1986.

During its first nine months of operation, from October 5, 1985 to June 30, 1986, the Lottery had total sales of $ 1.766 billion. By law, $886.3 million or 50 percent of the Lottery's revenues were returned to the public in prize money. An additional $ 202.3 million or 11.5 percent of the Lottery's revenues, went for Lottery expenses. The remaining $692.7 million, or 38.5

percent of the Lottery's revenues, including interest, were made available for use by the State's educational system as provided in law.

The Lottery is projecting revenues of $1.39 billion for fiscal year 1986-87 and has a proposed operating budget of $216.8 million. This includes $148.5 million for the cost of operating games and $68.3 million for administrative and other costs of conducting the Lottery's operations. A total of $695.2 million will be paid in Lottery prizes. This will leave an estimated $488.7 million for use in the State's educational system. Exhibit I.1 provides more detail on the Lottery's proposed budget for fiscal year 1986-87 and its proposed cost of operations.

To carry out its operations, the Lottery has organized itself into six major divisions and an Executive Office staff. Presently, the Lottery has 1068.6 full-time equivalent positions authorized to conduct its activities. Exhibit I.2 provides a listing of these divisions and shows the number of full-time equivalent authorized positions in each division.

The Lottery maintains two major administrative offices in the State, one in Sacramento and the other in Whittier. It also operates four regional offices and twelve district offices throughout the State to carry out its business activities.

SCOPE AND METHODOLOGY

The purpose of the Little Hoover Commission's study of the California State Lottery was to review the organization, operation, and performance of the Lottery and make recommendations to the Governor and the members of the Legislature regarding opportunities to improve the Lottery's operations.

To do this, the Commission did the following:

- Conducted two public hearings on the Lottery's operations;
- Performed interviews and fieldwork at the Lottery to collect information necessary to analyze the Lottery's internal policies, procedures and practices; and
- Conducted interviews with representatives from various State control and oversight agencies relating to the Lottery's activities, including the State Controller's Office, the Department of General Services, the Auditor General's Office, the Legislative Analyst's Office, and the Department of Finance.

The remainder of the report presents the results of our study of the Lottery and our recommendations for improving the Lottery's operations and performance.

EXHIBIT I.1
CALIFORNIA STATE LOTTERY
PROJECTED REVENUES AND EXPENDITURES (1)
FISCAL YEAR 1986/87 (2)

REVENUES	
On-Line Games	$ 514,936
Instant Ticket Games (Net of Returns)	875,416
Revenues	$1,390,352
PRIZES	$ 695,176
EXPENSES	
Game Costs	
Retailer Commission	$ 69,518
Instant Ticket Games Cost	21,229
On-Line Game Costs	10,661
On-Line Telecommunications	5,934
Advertising/Promotion/Public Relations	37,585
Courier Services	2,600
Bad Debt	1,000
TOTAL Game Costs	$148,527
Administrative and Other Costs	
Personnel Services	$31,385
Professional Services	5,692
Amortized Development Cost	4,601
Depreciation	11,388
Other Expenses	15,240
TOTAL Administrative and Other Costs	$68,306
TOTAL Expenses	$216,833
LOTTERY EDUCATION FUNDS	
Minimum Required Transfer to Education	$472,720
Excess Administrative Funds	5,624
Interest Income	10,428
Proposed Funds to Education	$488,771

NOTES: (1) All numbers expressed in thousands.

(2) California State Lottery Budget, Revised as of December 4, 1986.

EXHIBIT I.2
CALIFORNIA STATE LOTTERY
AUTHORIZED POSITIONS BY DIVISION
AS OF OCTOBER 1986

Division	Permanent Positions	Temporary Positions	Total Positions
Executive Division	40.8	1.0	41.8
Finance and Administration Division	296.5	36.7	333.2
EDP Operations Division	131.2	0.0	131.2
Retail Support Division	143.6	8.0	151.6
Marketing Division	22.0	0.8	22.8
Security Division	77.0	13.0	90.0
Field Operations Division	297.0	1.0	298.0
TOTALS	1008.1	60.5	1068.6

SOURCE: California State Lottery Personnel Section

II. THE LOTTERY NEEDS TO IMPROVE ITS PROCUREMENT PROCEDURES AND PRACTICES

The Lottery has a unique status as a state agency. Due to the special requirements established by Proposition 37, the Lottery has considerable flexibility in conducting its operations. As a result, the Lottery's business activities are not subject to many of the normal controls that are used to ensure efficient operation in other agencies. While this flexibility has allowed the Lottery to rapidly establish its operations, it has resulted in the Lottery failing to establish certain business systems and controls necessary in an operation of its size.

The Lottery's lack of adequate business systems and controls is particularly evident in its procurement function. This chapter discusses the problems that have occurred in the Lottery's procurement activities. Specifically, it describes the Lottery's extensive use of sole-source contracts, the lack of controls in its contract management system, the need to improve the Lottery's Request for Proposal development and evaluation process, and the inadequacies in its current bid protest procedures.

FINDING #1 - The Lottery Has Relied Too Heavily on the Use of Sole-Source Contracts to Purchase Goods

Since the Lottery initiated its business activities in early 1985, it has relied extensively on sole-source contracts to purchase goods and services. For example, the study showed that approximately 71 percent of the contracts for goods over $10,000 that the Lottery entered into during the past two fiscal years were sole-source contracts. Initially, the Lottery justified the use of sole-source contracts due to the need to acquire equipment, materials, and services in an extremely short time frame so that it could become operational as soon as possible. While this was expedient and may have been necessary at the outset of the Lottery's operations, the Lottery now needs to make greater utilization of the competitive bid process for contracts for goods and services. This will ensure that the Lottery is procuring goods and services at the lowest available cost and it will allow all responsible vendors the opportunity to bid on Lottery contracts.

Under the provisions of the Lottery initiative, Sections 8880.56 and 8880.60 of the Government Code, the Lottery is specifically exempt from standard State agency procurement and payment processes. It is also exempt from the standard provisions of the Public Contract Code, which establishes required contracting practices for state agencies. In addition, it is exempt from the contracting procedure guidelines in the State Administrative Manual (SAM). Moreover, under existing law, the Director of the Lottery has the authority to utilize his discretion to decide whether to use competitive bidding to purchase goods and services. Although the Lottery has adopted a documented competitive bidding process for certain goods and services, it continues to use sole-source procurement or limited-source procurement contracts for major purchases in many circumstances.

To analyze the Lottery's contracting practices, the Commission reviewed the consultant contracts that the Lottery issued during fiscal years 1984-85 and 1985-86. Exhibit II.1 provides the results of this analysis.

EXHIBIT II.1
CALIFORNIA STATE LOTTERY
CONSULTANT CONTRACTS
FY 1984/85 AND FY 1985/86

NUMBER OF CONTRACTS

	Number of Competitive Bids	Percent	Number of Sole Source	Percent	Total Number of Contracts	Percent
FY 1984/85	2	12.5	14	87.5	16	100.0
FY 1985/86	20	41.7	28	58.3	48	100.0
TOTALS	22	34.4	42	65.6	64	100.0

COST OF CONTRACTS

	Dollar Value Competitive Bid Contracts	Percent	Dollar Value Sole Source Contracts	Percent	Total Cost of Contracts	Percent
FY 1984/85	$ 30,826	21.9	$109,929	78.1	$ 140,755	100.0
FY 1985/86	1,403,324	55.8	1,112,783	44.2	2,516,107	100.0
TOTALS	$1,434,150	54.0	$1,222,712	46.0	$2,656,862	100.0

SOURCE: California State Lottery Contracts Log

Exhibit II.1 shows that the Lottery contracted for approximately $2.7 million in consulting contracts during the last two fiscal years. Of this amount, approximately $1.4 million, or 54 percent, went for competitively bid consulting contracts. However, approximately $1.2 million, or 46 percent, went for sole-source consulting contracts.

Similarly, the Commission analyzed the Lottery's procurement contracts for goods costing $10,000 or more during fiscal years 1984-85 and 1985-86. Exhibit II.2 presents the results of this analysis.

Exhibit II.2 shows that the Lottery spent approximately $12.6 million on the procurement of goods in the past two fiscal years. Of this amount, approximately $8.9 million, or 71 percent of the money spent on contracts for goods, was used for sole-source contracts. Only $3.7 million, or approximately 29 percent, went for contracts that were selected on the basis of competitive bids.

The Commission found that the Lottery's administrative staff typically try to procure goods and services in the most expeditious way possible. However, the Commission's review of the Lottery's contract and procurement practices suggests that the Lottery did not always procure goods or services at the lowest available price due to a reliance on sole-source or limited-source contracting. Moreover, some capable vendors may have been precluded from bidding on state contracts due to the Lottery's contracting practices.

For example, between February and May of 1986, the Lottery entered into a total of four lease/purchase agreements to obtain a total of 38 undercover/surveillance vehicles for its security division. The Lottery used telephone bids with follow-up documentation to obtain bids from three vendors for three of the four initial purchases. The Lottery's staff stated that although they contacted the Department of General Services Fleet Administration for assistance, it was the Lottery staff's understanding that the Lottery was unable to obtain undercover/surveillance vehicles through the Department of General Services in a timely manner.

However, officials from the Department of General Services Office of Procurement indicated to the Commission that the Lottery had not contacted them to try and procure undercover/surveillance vehicles. Representatives of the Office of Procurement stated to the Commission that as part of the Office's normal procedures, the Office routinely purchases undercover/surveillance vehicles for other state law enforcement agencies. In fact, during the same period of time that the Lottery was purchasing 38 undercover/surveillance vehicles, the Department of General Services Office of Procurement purchased identical vehicles at a lower price for several law enforcement departments. Exhibit II.3 presents a cost comparison of undercover/surveillance vehicles purchased by the Lottery and the Department of General Services.

Exhibit II.3 shows that the total cost difference between the 38 undercover/surveillance vehicles purchased by the Lottery and the Department of General Services totalled $37,293. Thus, the Lottery paid more for its undercover/surveillance vehicles than it would have paid if it had purchased the vehicles through the Department of General Services.

EXHIBIT II.2
CALIFORNIA STATE LOTTERY
PROCUREMENT CONTRACTS OVER $10,000
FY 1984/85 AND FY 1985/86 (1)

NUMBER OF CONTRACTS

	Number of Competitive Bids	%	Number of Sole Source	%	Total Number of Contracts	Percent
FY 1984/85	2	50.0	2	50.0	4	100.0
FY 1985/86	48	75.0	16	25.0	64	100.0
TOTALS	50	73.5	18	26.5	68	100.0

COST OF CONTRACTS

	Dollar Value Competitive Bid Contracts	%	Dollar Value Sole Source Contract	%	Total Cost of Contract	%
FY 1984/85	$ 78,042	62.4	$ 46,998	37.6	$ 125,040	100.0
FY 1985/86	3,624,053	29.1	8,830,409	70.9	12,454,462	100.0
TOTALS	$3,702,095	29.4	$8,877,407	70.6	$12,579,502	100.0

NOTE:(1) This information does not include data for "Instant Ticket" and "On-Line" Game contracts, or the Lottery advertising, promotion, and other services contracts.

SOURCE: California State Lottery Contracts Log

EXHIBIT II.3
COST COMPARISON OF SECURITY VEHICLES
PURCHASED BY THE LOTTERY AND THE
DEPARTMENT OF GENERAL SERVICES (1)

Type of Vehicle	Department of General Services Cost	Lottery Cost	Cost Difference	Number of Vehicles Purchased	Total Cost Difference
Ford-Crown Victoria(2)	$11,344	$12,947	$1,603	12	$19,236
Thunderbird (2)	12,039	12,058	19	13	247
Taurus (3)	10,885	12,255	1,370	13	17,810
			TOTALS	38	$37,293

NOTES: (1) Comparison of base price of security vehicles purchased exclusive of sales tax, license, and other lease costs.

(2) Purchased by the Department of General Services for the Department of Justice.

(3) Purchased by the Department of General Services for the California Highway Patrol.

A second example of the Lottery's failure to utilize competitive bidding more extensively is the Lottery's purchase of office furniture. Exhibit II.4 summarizes various office furniture purchases made by the Lottery in its first year of operation.

Exhibit II.4 shows that 10 of the 11 office furniture purchases that the Lottery made between May 1985 and June 1986 were made using sole-source contracts. These contracts totalled more than $554,000. The documented justification provided by the Lottery for this series of contracts to only two vendors was "to match existing furniture." In addition, the Lottery stated that it wanted to acquire furniture from the same vendor that was used by the original lessor of the building it occupied. The procedure used by the Lottery to make these purchases differs from Department of General Service's standard procedure that requires state agencies to competitively bid such contracts.

A third example of the Lottery's failure to obtain the lowest available costs is demonstrated in the Lottery's shipping costs. The Department of General Services reviews the Lottery's freight and shipping costs to identify potential improvements in the Lottery's shipping practices or corrections that need to be made in its shipping bills to reflect state billing rates. In fiscal year 1985/86, the Department of General Services reviewed 293 Lottery shipping invoices totaling $161,959. It determined that the Lottery could have saved money on 24 shipping invoices, or 8.2 percent of the invoices, by using state recommended shipping or ordering practices. These changes in the Lottery's shipping and ordering practices would have resulted in a savings of $2,987.00, or 1.9 percent, of the total billings reviewed. In addition, the Department of General Services corrected 41 shipping invoices, or 14 percent of the invoices reviewed, to reflect proper state billing rates.

Recently, the Lottery provided the Commission with additional information regarding its shipping costs. While the Lottery acknowledges that it has been overcharged for shipping costs in some instances, the Lottery believes that such overcharges represent a relatively small percentage of its overall shipping costs.

The examples cited above were extracted from a limited review of the Lottery's contract files. However, these examples indicate that the Lottery has incurred unnecessary expenses by relying too heavily on sole-source or limited-source contracting for goods and services, by not using competitive bid processes, or by failing to use the procurement services available through the Department of General Services.

FINDING #2 - The Lottery's Contract Management System Does Not Provide Adequate Controls

The Lottery's current contract management system does not provide adequate controls over contracting activities. The review of the Lottery's contract management system revealed that certain contracts are not being monitored or tracked, some contract files do not contain sufficient information to monitor contract performance, and current procedures are inadequate to ensure proper control of contract performance and payments. As a result, in some instances the Lottery has exceeded allowable contract payment limits and received goods or services without a valid contract in effect. Moreover, this undermines the Lottery Commission's ability to exercise control over the Lottery's expenditures.

EXHIBIT II.4
SUMMARY OF METHODS USED BY THE LOTTERY
TO PURCHASE FURNITURE

Vendor	Purchase Date	Amount of Bid Purchases	Amount of Sole Source Purchases
Office Industrial Furnishers	5-5-85	$50,291.70	$ -0-
	6-12-85	-0-	33,597.76
	6-13-85	-0-	13,400.52
	9-10-85	-0-	15,561.86
	5-10-86	-0-	10,544.83
	SUB-TOTALS	$50,291.70	$73,104.97
Western Contract Furnishers	1-15-86	$ -0-	$315,805.00
	1-15-86	-0-	26,317.00
	2-18-86	-0-	28,688.69
	3-11-86	-0-	24,478.69
	3-27-86	-0-	26,317.00
	6-1-86	-0-	59,694.00
	SUB-TOTALS	$ -0-	$481,300.38
	TOTALS	$50,291.70	$554,405.35

SOURCE: California State Lottery Contracts Log

The Lottery's contract management activities are performed in three major areas. These include:

- Contracts Services Unit -- responsible for preparation of contract documents and following up on the review and signature of contract documents. In addition, the Contracts Services Unit is responsible for maintaining information on the number, type and amounts of contracts. It also is responsible for tracking the open or closed status of contracts and for monitoring contract performance information.

- Expenditure Accounting Unit -- responsible for establishing a payment file once a contract is executed and for making payments on contracts.

- Individual Operational Units -- responsible for initiating contracts, participating in the negotiation of contract terms, and determining if sufficient funds are available for a contract. In addition, individual operational units monitor the performance of contracts and provide approval of payments for goods or services received.

The Commission's review of the Lottery's contract management system identified several problems. First, the review showed that the Lottery is not adequately monitoring and tracking contracts. For example, the Lottery's Monthly Contracts Report does not accurately reflect the status of several major contracts. On the Monthly Contracts Reports dated November 4, 1986 and December 4, 1986 that were presented to the Lottery Commissioners on November 12, 1986 and December 10, 1986 respectively, no mention is made of either the original or the amended contracts with Martin-Marietta Data Systems for software licensing and consultant services. The cost of this contract, as amended, exceeded $143,000.

As a further example, the original contract with Battelle Columbus Division, the Lottery's chief On-Line Games consultant, was not reflected in the Lottery's contracts report until November 4, 1986. However, the original contract with Battelle, in the amount of $180,000, had been approved by the Lottery Commission on September 4, 1986 even though, the actual term of the contract commenced on July 22, 1986 when the contractor began work.

Second, the Commission's review revealed that some contract files do not contain sufficient information to monitor contract performance. A review of the contract files in both the Expenditure Unit and the Contracts Services Unit indicated that in many cases the contract files were incomplete. Documentation of the justification for the type of contract and contract vendor selection was incomplete in the Contracts Services Unit files. In addition, the status of the files were not current in various files reviewed in the Expenditure Accounting Unit. Furthermore, staff in the Expenditure Accounting Unit and the contract managers in the operational units have not established a procedure to close contracts upon completion of contract performance. As of November 1986, a closed contract file for current year contracts did not exist at the Lottery.

Third, the Lottery's current contract monitoring procedures are inadequate to monitor contract payment or performance. This potentially allows the Lottery to exceed payment limits, or to receive goods and services without a valid contract in effect. An example of this is one of the Lottery's contracts with Peat, Marwick, Mitchel & Co. (PMM) for work on the Lottery's financial statements. In September 1986, the Finance and Administration Division began negotiations with PMM for an extension of an existing $75,000 contract. This was done on the assumption that an additional $25,000 could be added before meeting the $100,000 threshold that the Lottery Commission uses to require its approval. The on-site staff of PMM continued their work on the assumption that this contract extension would be approved. However, the Finance and Administration staff was not aware that the Internal Audits Unit had entered into a second contract with PMM. Thus, the two existing contracts combined totalled in excess of $100,000. Therefore, any amendment of either contract would require formal Commission approval. When the proposed amendment was submitted to the Contracts Services Unit, they refused to process the amendment without formal Commission approval.

When the Finance and Administration Division was informed that Commission approval would be required, it immediately notified PMM on-site staff to complete existing assignments and depart within four days. However, the total contract costs from PMM to the Finance and Administration Division totalled approximately $82,000. As a result, the Director of the Lottery placed a contract amendment approval request before the Lottery Commission in late October to correct this error on the part of the Lottery staff.

Fourth, due to the fragmented nature of the Lottery's contract monitoring and control system, operational units that have required services sometimes obtain such services without an approved contract. A recent example of this is the issuance of an emergency contract for ticket testing services to Battelle Laboratories for the period from September 15, 1986 through September 14, 1987. The Lottery's existing contract for services by an independent ticket testing agency expired as of June 30, 1986. During the period from July 1 through September 15, 1986, the Lottery let two major contracts for the procurement of instant game tickets. As a part of at least one of the contract evaluations, ticket testing was conducted by Battelle Laboratories without a contract for such services being in effect. The contract for this service was subsequently issued on an emergency basis effective September 15, 1986.

Fifth, the Lottery's current contract process does not provide for the proper and timely flow of information to the Lottery's Budget Section for inclusion in the Lottery's budgetary process. The Budget Section of the Finance and Administration Division is usually consulted by an operational unit prior to beginning the contract process. However, independent reviews by both the Commission's staff and the State Controller's Office have indicated there is no formal method to budget and track contract performance. This function is left up to the individual contract managers in the operational units as a part of their overall responsibility. Thus, the Budgets Section does not have a procedure in place to monitor budgetary implications of payments for ongoing contracts.

While the Lottery has stated that many of its contracting and contract monitoring practices are necessary to avoid more time consuming State

contracts procedures, the Commission's review identified major deficiencies in the Lottery's contract management system that need to be addressed immediately to avoid financial problems and maintain the integrity of the Lottery's contracting process.

FINDING #3 - The Lottery Needs to Clarify and Improve its Request for Proposal Development and Evaluation Process

The Lottery has received considerable criticism from prospective vendors regarding the process it uses for issuing Requests For Proposals (RFPs) for the procurement of goods and services. Specifically, vendors have raised concerns regarding the completeness and clarity of the Lottery's RFPs and the methods it has used to evaluate proposals. The Commission's review of these concerns indicated that the Lottery needs to further improve its RFP preparation and proposal evaluation processes so that vendors have a better understanding of what the Lottery seeks to procure and how the Lottery evaluates proposals. For example, the review of the RFP for the most recent instant game ticket contract showed that the Lottery did not adequately define the services the Lottery wanted, the bid bond or letter of credit requirements, and the scoring methodology to be used in evaluating proposals.

The Lottery uses a process similar to that used by other state agencies to develop its Request for Proposals for goods and services. Generally speaking, the Lottery's RFPs are designed to do the following:

- Define the nature and specifications of the products or services desired;
- Identify the minimum required performance criteria for bidders, such as prior performance, bonding, subcontracting, etc.; and
- Describe the proposal evaluation criteria and scoring methodology.

Once the Lottery develops and issues an RFP for goods or services, vendors have the opportunity to prepare proposals and submit them to the Lottery in response to an RFP.

During the past year, the Lottery has utilized RFPs for the purchase of a major telecommunication systems, on-line LOTTO games and related services, advertising services, and two instant ticket games contracts. Vendors have made queries regarding the specifications presented by the Lottery in RFPs and regarding the RFP evaluation process on a number of prior contracts.

The most noteworthy example of problems that the Lottery has had in developing, issuing, and evaluating RFPs is the process that the Lottery used for the multiple game instant ticket contract executed in September 1986. Each of the three losing bidders questioned the Lottery on a number of different points regarding specifications of the RFP and the Lottery's evaluation of proposals. Specifically, these vendors raised five major concerns during the Commission's public hearing on this matter.

First, each of the three of the losing bidders questioned the change in requirements for the RFP's bid bond. In the original RFP, the Lottery

required a bidder's bond of $800,000. The bidders were notified subsequently by letter on the day prior to the closing date for bid acceptance that a letter of credit could be substituted for the bid bond. Each of the three losing bidders obtained a bid bond; however, the winning bidder submitted a letter of credit. The Lottery has stated that this change of requirement was made to accommodate all the bidders and not simply to favor a particular bidder.

Second, vendors expressed concern about the Lottery staff's use of a "sample game" to calculate and award scores in the cost component of proposals submitted. Instead, the losing vendors believed that the cost evaluation should have been done on the basis of base ticket price bids. The "sample game" basis for cost evaluation was constructed from several different parts of the RFP and was not stated to be the basis for cost evaluation in the RFP. The Lottery has stated that "the cost scoring was designed to achieve a more realistic comparison of the the actual cost that the Lottery would incur . . ." While this may be the case, the RFP did not accurately reflect the proposed scoring methodology for cost to be used by the Lottery staff in its evaluation of proposals.

Third, the Lottery gave additional credit in the evaluation process to the winning vendor for the organization and staffing and the cost components of its proposal because the vendor committed five full-time professional staff to work on-site at the Lottery. During a required bidder's conference, the Lottery indicated to bidders that on-site vendor staff should be provided on an "as-needed" basis as was not a specific requirement of the RFP. It should also be noted that the winning vendor on this RFP, which had been the winner of the prior instant ticket contract, already had five full-time staff on-site at the Lottery for almost a year.

Fourth, during the evaluation process for the multiple game instant ticket contract, Lottery staff made a calculation error in determining scores in one critical category--Quality of Tickets. However, Lottery staff stated during the bidder appeals review that "The calculation error in that one section did not affect the final recommendation."

Finally, the fifth problem identified in the multiple game instant ticket contract was that each of the losing bidders raised questions regarding the methods used to allocate points for each category in the evaluation. To date, there has been no specific explanation from Lottery staff of the specific system used to allocate points by category, except for the system used by the Lottery's Affirmative Action Office for its portion of the evaluation. Moreover, no specific system for scoring was contained in the RFP to provide prospective bidders a clear indication of how proposals would be evaluated.

Due to the problems that have been identified in the clarity and preciseness of the Lottery's RFP development and evaluation process, prospective vendors have stated that they have had difficulty responding to the Lottery's RFPs. This could have a negative impact on the ability of the Lottery to procure needed goods or services in a cost-effective manner.

FINDING #4 - The Lottery Does Not Use an Independent Review and Appeals Process to Resolve Contract Disputes.

The Lottery is required by statute to establish and use a formal bid protest procedure for certain types of contracts. In meeting this requirement, the Lottery has established an appeals procedure that is administered by the Lottery Director. Since the Lottery Director is involved in making initial procurement decisions, the Lottery's current bid protest procedure does not have the appearance of independence and its objectivity in reviewing bid protests and appeals can and has been questioned. Moreover, the process that the Lottery uses to review bid protests and appeals differs considerably from and contradicts the independent review and appeals process being used by other state departments.

The California Government Code, Section 8880.56(b)(1), regulates the contracting protest and appeals procedures for contracts issued by the California State Lottery. This section states:

> ". . .with respect to the procurement for the printing of lottery tickets, or the acquisition of any electronic computer, including any software used in conjunction therewith, the Commission shall adopt and publish competitive bidding procedures for the award of any procurement or contract in order to ensure the fullest competition of the procurement. These procedures shall include a bid protest procedure."

On July 9, 1986, the Lottery adopted a formal set of competitive bidding procedures pursuant to Government Code, Section 8880.56(b)(1). Sections 11 through 18 of the Lottery's procedures specify the form in which the contract award protest is to be submitted and the time period in which it shall be submitted. These sections further specify the manner in which these protests shall be resolved. Specifically, Section 12 states, in part, "At the sole discretion of the Lottery Director, the Director may conduct a hearing, appoint a hearing officer to make a recommendation to the Director, or resolve the protest himself based solely on the written protest." As of mid-November 1986, all formal protests to contract awards for goods or services have been resolved by the Lottery Director based upon his review of the process and evaluation for each contract award. In some cases, the same staff members that were involved in awarding the original contract also were involved in the review of the contract appeal.

The process of contract award appeals at the Lottery can best be illustrated by the handling of the protests to the award of the multiple-game instant ticket contract on September 4, 1986 and September 12, 1986. At the September 4, 1986 Lottery Commission hearing, Lottery staff presented the Director's recommendations to contract with a vendor for the multiple game instant ticket contract. The Lottery Commission, after taking public testimony, postponed approving the recommended award pending the Director's evaluation of each of the three losing vendors' protests.

A memorandum submitted on September 11, 1986, from the Director to the Lottery Commissioners regarding the resolution of the multiple-game instant ticket contract states, in part:

> ". . . the protest letters were evaluated by the Director, with the assistance of the evaluation staff, between September 4, 1986 and September 11, 1986. Reponses to the protests were coordinated by Nancy Sweet, Legal Counsel; she assigned the individual protest items to the evaluation staff for research and analysis. The subject matter of the protests varied considerably, . . . additionally, the protest letters offered several items of new information not considered in the original evaluation. The evaluation staff completed a report on the protest items, which was submitted to me on September 10, 1986."

The memorandum concludes by stating:

> "I had been in continuous contact with the members of the evaluation staff between September 4 and September 10 in connection with the issues analyzed in the report. For the reasons stated in the report, I then denied the three protests by separate letters to the three vendors on September 11, 1986. The analysis of each protest was included as an attachment to each letter. I fully believe that the evaluation process was conducted fairly and according to the terms of the RFP and recommend that the State Lottery Commission approve the award to Scientific Games, Inc."

Attached to this was a staff memorandum dated September 10, 1986 from the members of the original contract proposal evaluation team, stating in part that ". . . none of the issues raised had any merit, and we will reaffirm our original recommendation. . ." Based upon the Director's above-stated resolution of the contract appeals, the Lottery Commission on September 12, 1986, voted to approve the Director's original recommendation of contract award.

The appeals process used by the Lottery in this case varies considerably from the process used by other State departments for protest resolution on contract disputes. For example, protests on contract awards from the Department of General Services, Office of Procurement, are first reviewed by the Director of the Department and then delegated to staff. If no settlement of the protest and appeal can be reached with the protesting vendors, the protest along with all supporting documentation by both the vendor and the Department is submitted for resolution to the State Board of Control, an independent agency not contained within the Department of General Services. The Board of Control has the power and the sole discretion to uphold or deny the protest. If the protest is upheld, the Department of General Services must then either award the contract to the protesting bidder, or rescind and revise the contract bid proposal and then rebid the contract. Any subsequent appeals, as necessary, may be taken through the civil court system.

The Lottery's current contract appeals process allows for no appeal to a higher, independent level, but rather it is handled by the authority that made the original recommendation and decision that is being appealed. In addition, it does not allow for appeals to be reviewed by a separate independent authority other than that of the civil courts. Because the Lottery's appeals process does not involve an independent third party, its process does not have the appearance of independence and its objectivity can be questioned.

III. THE LOTTERY NEEDS TO FURTHER REVIEW ITS EXISTING RELATIONSHIP WITH CERTAIN CONTRACTORS

The Lottery has established a major business presence throughout the State of California since the passage of Proposition 37 in November 1984. To do this, the Lottery has had to procure millions of dollars worth of goods, services, and materials. The Lottery has received some criticism from unsuccessful vendors regarding the business dealings of some of the successful contractors.

Since the Lottery industry is a highly competitive growth industry, a certain degree of competitor criticism can be expected. However, after reviewing the concerns that had been voiced by unsuccessful vendors, the Little Hoover Commission decided that two particular criticisms of the Lottery's current contractors warranted further review. Specifically, the Little Hoover Commission reviewed the concerns related to the minority business enterprise subcontract relationship of the current instant game ticket contractor. The Commission also reviewed alleged business relationship of the current instant game ticket contractor in South Africa. This chapter presents the Little Hoover Commission's findings in each of these areas.

FINDING #5 - The Lottery Needs to Further Review the Minority Business Enterprise Subcontract Relationship of the Current Instant Game Ticket Contractor

The vendors that competed for the Lottery's recent multiple-game instant ticket contract have raised concerns regarding the validity of the subcontracting relationship between Scientific Games, Inc. and its minority subcontractor, Security Packaging, Inc. The multiple-game instant ticket contract was formally awarded to Scientific Games, Inc. on September 12, 1986, in part as a result of the minority subcontractor participation of Security Packaging, Inc. The Little Hoover Commission's review indicates that the competing vendors have raised questions regarding Security Packaging, Inc.'s subcontracting relationship with Scientific Games, Inc. that warrant further review by the Lottery. Specifically, there are questions regarding the employment status of current Security Packaging, Inc. employees that formerly worked for Scientific Games, Inc. There are also concerns regarding the degree to which Scientific Games, Inc. controls the operations of Security Packaging, Inc.

Sections 8880.56(b)(3) and (4) of the Government Code specify the requirements for the provision of minority subcontractors that the Lottery must adhere to when preparing RFPs for purchases totalling over $500,000. Pursuant to these requirements, the Lottery issued an RFP on July 25, 1986, for the multiple-game instant ticket contract. This RFP stated:

> "Section 4.6.1 Minority Women-Owned Businesses. The California State Lottery (CSL) shall require all bidders or contractors to include specific plans or arrangements to utilize subcontracts with socially and economically disadvantaged small business concern for contracts exceeding $500,000. The subcontract plans shall specifically identify the feasibility of utilizing the subcontract services; indicate the percentage of contract dollar/actual contract dollars to be

subcontracted; and identify the subcontractor(s), if known (Government Code, Section 8880.56(b)(4)."

The use of minority subcontractors was made a criterion for award of contract, and was assigned a weight of 10 percent of the final evaluation.

As a part of the RFP response prepared and submitted by Scientific Games, Inc. (SGI), SGI proposed the use of four minority/women subcontractors to provide various services. One of these subcontractors, Security Packaging, Inc. (SPI), was to provide packaging of lottery tickets at the SGI production facility in Gilroy, California. SGI stated that this subcontractor was qualified as a minority subcontractor by virtue of its ownership. The Chairman and Chief Financial Officer, a Hispanic, owned 54 percent of the firm. The President of SPI, a woman, owned 46 percent of the firm. The President and another key employee of SPI were identified at the time that the bid proposal was submitted, August 7, 1986, as former employees of SGI at both its Gilroy, California and Sparta, Michigan production facilities. As a part of the bid proposal, SGI committed to subcontracting a total of 8.12 percent of the total contract cost, or $2,679,600, to SPI. As a result of this subcontract, SGI was awarded 7.2 of a total 10.0 points in the minority participation portion of the bid evaluation. SGI was awarded the contract on September 12, 1986 with a leading total of 79.9 points out of 100.0 points in all areas of evaluation.

Subsequently, as a part of the contract appeals process, one of the losing bidders stated that SGI should not have been given credit for the SPI subcontract because SPI was in fact managed and controlled by SGI and its affiliates. The losing bidder stated that the President and key employees of SPI were current employees of SGI at the Gilroy facility. The Lottery's reply to this as a part of the appeals evaluation was:

> "The California State Lottery's Contract Compliance Office (CCO) has a responsibility to monitor compliance with the Lottery's subcontracting policy. We will fulfill that responsibility in this case and all others."

The Lottery further stated that, even if the SPI subcontract not been considered as a factor, the relative rankings on the evaluation would not have been affected.

When questioned about this at this Commission's October 29, 1986 hearing on Lottery operations, officials from the Lottery stated that the Lottery's staff was reviewing this situation and that they would make a report of their findings at some future date to the Director of the Lottery. The Director then would appraise the Lottery Commission of the findings and make such recommendations as were necessary.

When questioned about this at the November 29, 1986 Lottery vendor's hearing, Dr. John Koza, President of Scientific Games, Inc., stated that SGI owns no stock or any other financial interest in SPI, and that only two of the key employees and six of the 101 hourly employees of SPI were former SGI employees. These statements were repeated in the amended written testimony submitted by SGI subsequent to the hearing on December 4, 1986. These statements, however, appear to contradict SGI's earlier statement contained

in the original written testimony submitted the day of the hearing, November 19, 1986. At that time SGI stated:

> "In order to meet the experience requirements of the Lottery's RFP and the 'daily management' requirements there are many former Scientific Games employees that are now working for Security Packaging."

Subsequent review by the Little Hoover Commission of the relationship between SPI and SGI has raised several concerns and questions. First, exactly how many of SPI's employees are former employees of SGI? When and under what circumstances did these employees change employment? What became of the SGI employees working in the packaging section of the Gilroy plant after the final delivery of tickets under the old instant ticket contract?

Second, what was the employment status of SPI's key employees noted in the RFP bid? SPI was incorporated with the Secretary of State's Office on July 24, 1986, listing the "initial agent for service" as the company's president. This person appears to have remained an SGI employee for some time after this date.

Under the terms of the subcontract between SGI and SPI, the subcontractor is required to perform all work at the contractor's facility, using equipment owned by the contractor and under the quality control and security requirement of the contractor. All physical plant facilities are leased by the subcontractor from the contractor subject to the contractor's sole discretion as to location and utilization. The specifications and pricing of subcontractor services are solely within the discretion of the contractor. These provisions, among others, raise concerns about the independence of both overall and day-to-day management and control of SPI.

The Little Hoover Commission is concerned about these apparent discrepancies of fact and the day-to-day and overall management control within the SPI organization. While the Little Hoover Commission did not have the resources necessary to fully investigate the relationship between SGI and SPI, the review raised several questions that the Lottery's Contract Compliance Office should further investigate.

FINDING #6 - <u>The Lottery Commission Needs to Review the Statements that the Current Instant Game Ticket Contractor has Made Regarding its Business Involvement in South Africa</u>

The vendors that competed for the multiple-game instant ticket contract raised concerns regarding whether the current instant game ticket contractor, Scientific Games, Inc. or its parent company, Bally Manufacturing, Inc. had business relationships in South Africa. Although two of the three losing vendors competing for the multiple-game instant ticket contract testified before the Little Hoover Commission that they had business relationships with South Africa, the vendors questioned whether Scientific Games, Inc. misrepresented of its business relationships in South Africa in testimony before the Legislature in an effort to secure a contract with the Lottery. Under California law it is not illegal to do business in South Africa; however, the State recently passed legislation to divest its investments in South Africa.

The review of statements made by SGI to the Legislature and the Little Hoover Commission in oral and written testimony apparently contradict. For example, SGI testified to the Little Hoover Commission that neither it nor its parent

company, Bally Manufactoring, Inc., had business relationships in South Africa. However, written documents submitted by Bally to the Legislature state that from 1983 to 1986 Bally sold slot machines adapted for South African coins to a distributor, David Mercer International, which were destined for South Africa. Thus, there is a question whether or not misrepresentations did occur before the Legislature. If so, the Lottery Commission should determine if any actions are warranted with respect to Scientific Games, Inc.'s current Lottery contract.

On June 24, 1986 a Joint Hearing was held by the Assembly and Senate Governmental Organization Committees on the California State Lottery. In the course of that hearing, Lottery staff were questioned by one of the committee members, Assemblywoman Maxine Waters, about the extent of business dealings of the current instant game ticket contractor, Scientific Games, Inc. (SGI), or its parent company, Bally Manufacturing Inc. (Bally), in South Africa. The reply from Lottery staff, relaying the information received in a letter from SGI was:

> "With respect to the South Africa question, neither Scientific Games or its parent corporation, Bally Manufacturing Corporation does any business, whatsoever, in South Africa."

No further questions on the subject were raised at this time.

On September 3, 1986, Lottery Production Services (LPS) filed a formal appeal of the award of contract of the multiple instant game ticket contract to SGI. As a part of this appeal, LPS stated that it had discovered that SGI's parent company, Bally, had in fact been conducting business in South Africa. Representatives of LPS at both the September 4, 1986 and September 12, 1986 Lottery Commission public meetings also repeated these statements, and stated that it was a matter of concern to Californians whether the Lottery should contract with businesses that had dealings in South Africa. At the September 12, 1986 Lottery Commission meeting, the appeals raised by each of the three losing vendors, and all the points therein, were deemed to be without merit by the Lottery's Director. Based on the resolution of the appeals by the Director, and upon the prior recommendation of vendor selection, the Lottery Commission then awarded the instant game ticket contract to SGI.

On September 11, 1986, the Secretary and General Counsel of Bally sent a letter to the Director of the Lottery stating that the company and its affiliates had no investments, assets, offices or employees in South Africa (see Appendix B). On September 17, 1986, the Chairman of the Assembly Government Organization Committee sent Bally a four-page letter asking 19 specific questions about Bally's business involvement in South Africa, including its relationship with specific distributors, the manufacturing and shipping of slot machines, the availability of other contracted gaming services, and the sequence of ownership of certain slot machines. Bally's Secretary and General Counsel replied on October 1, 1986 stating that he had been out of the country and had been unable to reply. He indicated that he would respond as soon as possible to these questions.

On October 10, 1986, Bally replied to the Committee's inquiry with a three-page letter with attached exhibits (See Appendix B). In the letter, Bally indicated that it was not engaged in business in South Africa. Bally

stated that its last transaction in South Africa had been the sale of 30 slot machines by a Bally foreign subsidiary in June 1984. Bally further stated that it believed the Legislature was being misled by one of the losing bidders (LPS), which had supplied "false information" to the Committee. However, in the attached exhibit to Bally's reply to the Committee's specific questions, Bally stated that from 1983 to 1986 it had sold slot machines adapted to take South African coins to a distributor, David Mercer International (DMI), which were destined for South Africa. The machines were shipped to the ultimate purchaser in South Africa by Bally FOB from its manufacturing plant in Illinois. Bally further indicated that it maintains no ownership interest in DMI and that no employees, officers or directors of Bally serve as employees, officers or directors of DMI.

On October 14, 1986, the Vice President and General Counsel of SGI sent a letter to the Chairman of the Assembly Government Organization Committee, also addressing this issue. In the letter, SGI stated again that neither it nor its parent company, Bally, did business in South Africa. SGI further stated that the company (LPS) that originally raised the question as part of the contract appeal on September 4, 1986 did have a parent company, Southam, Inc. with business interests in South Africa. SGI closed by stating that it was sorry that the Committee had "been drawn into this extended controversy," and hoped that the issue had been resolved.

On October 29, 1986, the Commission held a hearing on the organization and operations of the California State Lottery. At the beginning of the hearing, a staff member of the Assembly Government Organization Committee presented a letter from the Committee Chairman to the Little Hoover Commission. In the letter, the Committee Chairman stated that he was concerned that legislative committees may have been misled about SGI and Bally's business involvement in South Africa. He referred to Bally's letter of October 10, 1986 with attachments, and stated that "A close examination of Bally's detailed responses, which accompany their letter, contradict the assertions made in the main body of the letter." He pointed out that Bally admitted it was selling gaming machines to a distributor which it (Bally) knew were destined for South Africa. The machines were specifically manufactured by Bally for use in South Africa, and were shipped FOB from Bally's manufacturing plant directly to South Africa. The Committee Chairman then stated "This is doing business in South Africa to my understanding." He closed the letter by indicating that the issue appeared to be whether the Legislature and the Lottery Commission were misled by the contractor, and whether, if they were so misled, the Lottery Commission should take steps to suspend the contract then in force on the grounds that these misstatements constituted dishonest conduct and so compromised the integrity of the State Lottery.

The Director of the Lottery was questioned at the same hearing by the Little Hoover Commission regarding the Lottery Commission's concerns and actions on this issue. In reply to a statement from a Commissioner regarding the Director's earlier statement to the news media that "Obviously, it would be of great concern if we found out they were lying," the Director replied:

> "That is correct. To the best of my knowledge it is, and that's if they have been shown that they are lying. Obviously, we have seen the same letters that Assemblyman Condit has seen from the Bally Manufacturing which indicate in language from those two companies that Bally or

> Scientific Games are not doing business in South Africa. The assertion has been made this morning that they are indeed still doing business there. And until someone comes forward and indicates where the facts are, I think it's premature for us to make an assessment about whether Scientific Games or Bally has been lying about this."

The Lottery's Director further stated that he would share the correspondence and information with the Lottery Commission and then decide if any action would be necessary regarding SGI's contract with the Lottery.

On November 19, 1986, the Little Hoover Commission held an additional public hearing to take testimony from vendors regarding the contract and procurement practices of the Lottery. In both written and oral testimony, Dr. John Koza, President of Scientific Games, Inc., stated:

> "On June 24, we said, through Mr. Guiterrez, that neither Scientific Games nor Bally (our parent), nor any subsidiary of Bally, was doing business in South Africa. There are no employees, assets, investments, plant, offices in South Africa. There never have been. The statement was true on June 24, it's true today, it's been true at every moment in-between. I repeat the statement today."

Dr. Koza further stated that the parent companies of each of the three losing bidders had some degree of business involvement in South Africa.

Independent of, and prior to Dr. Koza's statements, two of the other three vendors had been questioned by Commission members or staff regarding the business involvement of the bidding companies, its parent company, and subsidies or affiliates in South Africa. Each of the two bidders present indicated that, to the best of their knowledge, their parent companies or affiliates did have some degree of business involvement in South Africa.

Finally, on November 25, 1986, the Chairman of the Assembly Committee on Governmental Organization sent a letter to the Executive Vice President and Chief Legal Counsel of Scientific Games, Inc. In the letter the Chairman stated:

> ". . . the issue before the Governmental Organization Committee regarding South Africa and Scientific Games rests solely on the statements made by Scientific Games to the Legislature's Committees on Governmental Organization stating that neither Scientific Games, nor its parent corporation Bally Manufacturing, does <u>any</u> business in South Africa."

He further stated:

> "It is clear from the background information provided by the Bally Manufacturing Corporation that Bally has extensive dealings in South Africa."

The Chairman concluded:

> "The only remaining questions are whether Scientific Games' and Bally's statements to California governmental entities were deliberate

> misrepresentations constituting sufficient reasons to involke Sections 8880.24 and 8880.35 of the Government Code (the California State Lottery Act) and, if so, should California revoke Scientific Games' contract with the Lottery Commission."

To date, this Commission has learned of no further action on this matter by the Lottery. The Commission is concerned and believes that this issue must be thoroughly reviewed and resolved by the Lottery Commission so that the continuing integrity of the Lottery will not be questioned.

IV. THE LOTTERY NEEDS TO IMPROVE ITS FINANCIAL ACCOUNTABILITY AND CONTROL

The staff at the Lottery have worked hard to establish the business systems, procedures and controls necessary to operate a major enterprise. While the Lottery has accomplished a great deal in a short time frame, there are additional actions that need to be taken to further improve the Lottery's financial accountability and controls.

This chapter discusses three areas which the Little Hoover Commission identified that need to be addressed to fully ensure that the Lottery's expenditures are justified. Specifically, this chapter presents findings relating to the Lottery's lack of a system to identify and recover unclaimed low-tier prizes, its lack of timely or complete financial reports, and the fact that the Lottery is exempt from an independent annual budgetary review by the Legislature.

FINDING #7 - The Lottery Does Not Have a System to Identify and Recover Unclaimed Low Tier Prizes

Under the provisions of Proposition 37, the Lottery Initiative, unclaimed Lottery prize money reverts directly to the Lottery Education Fund. However, to date, the Lottery has made no attempt to recover unclaimed low-tier prizes currently paid out by Lottery retailers. In addition, the Lottery has made no attempt to accurately determine the amount of this unclaimed low-tier prize revenue. While no accurate data is available on the extent of unclaimed low-tier prizes, estimates indicate that the Lottery's failure to recover unclaimed low-tier prizes may have resulted in a $13.8 to $34.6 million loss in funds to the State educational system during the Lottery's first nine instant ticket games.

Section 8880.32 (e) of the Government Code requires that unclaimed Lottery prize money reverts to the Education Fund of the Lottery. Further provisions of the Lottery Act Sections 8880.32(a) and (d) of the Government Code, allow the Lottery Commission to specify that lottery winners of less than either $600 or $25 may be paid by the lottery game retailer from whom the winning ticket was purchased. These prizes are called low-tier prizes. Low-tier prizes may also be redeemed through the Lottery's Prize Validation Unit. This system, also used in a number of other state lotteries, is known as the Guaranteed Low End Prize System (GLEPS).

GLEPS works as follows: Lottery retailers purchase blocks of 500 tickets at a discount, rather than paying the full price of $500. This discount ranges from $155 to $193 on any given game and is intended to provide the retailer with his 5 percent commission ($25) and a discount for funds that the retailer will pay out to "low-tier" prize winners ($130-$168). The Lottery retailer is not required to keep track of the number of low-tier prizes that he pays out for any given block of tickets. Lottery officials are aware that an unknown number of low-tier prizes are never redeemed by the people purchasing tickets. As a result, the Lottery retailers are keeping unclaimed prize money from these low-tier prize winning tickets because they are not required to account for their low-tier prize payments.

Estimates vary widely as to the amount of unclaimed low-tier prizes reverting to retailers. Exhibit IV.1 shows the range of amounts of unclaimed low-tier

EXHIBIT IV.1
ESTIMATED AMOUNT OF UNCLAIMED LOW-TIER
PRIZES FOR GAMES 1 THROUGH 9 (1)

Estimated Amount of Unclaimed Low-Tier Prizes
By Estimated Percent of Unclaimed Tickets

Game	2 Percent	3 Percent	4 Percent	5 Percent
1	$1.929	$2.894	$3.858	$4.823
2	1.383	2.075	2.766	3.458
3	1.987	2.980	3.973	4.967
4	2.026	3.039	4.052	5.066
5	1.871	2.807	3.742	4.678
6	1.343	2.014	2.686	3.358
7	0.898	1.347	1.796	2.245
8	1.025	1.538	2.051	2.563
9 (2)	1.359	2.038	2.718	3.397
TOTALS	$13.821	$20.732	$27.642	$34.555

NOTES

(1) All numbers expressed in millions.

(2) Based on estimated ticket sales for game 9 that ends in December 1986.

prizes based upon the guaranteed low-tier prize system amounts and an estimated percentage of the unclaimed low-tier prizes for each game. Through Game 9, which will end in December, 1986, these unclaimed low-tier prizes that revert to Lottery retailers are estimated to total from $13.8 million to almost $34.6 million dollars. This represents Lottery prize money that should revert to the State educational system that is not being collected by the Lottery.

The Lottery has made no effort to date to recover these unclaimed prizes or to make a detailed estimate as to the amount of unclaimed prize money retained by Lottery retailers. Lottery staff have indicated that there are a number reasons for this. First, the Lottery offers the unclaimed low-tier prizes to vendors as an incentive, or bonus, to cover the cost of administration for the Lottery ticket sales. In this way, the Lottery hopes to retain as many of their lottery ticket retailers as possible who might otherwise not sell Lottery tickets due to the perceived administrative cost of selling tickets.

Second, Lottery officials indicate that they do not believe that they are legally required to recover such low-tier unclaimed prizes. They point to language from Government Code Section 8880.32(e), which they interpret as providing the Lottery the discretion to either recoup or not recoup unclaimed low-tier prizes from retailers. The specific language reads: "If a valid claim is not made for a prize directly payable by the Lottery Commission within the period applicable for that prize, unclaimed money shall revert to the benefit of the public purpose described in this chapter." The Lottery's policy is that low-tier winning tickets should be redeemed by the selling retailer, and that the Lottery itself only redeems these tickets as a convenience to the public. Therefore, the Lottery interprets the key phrase "directly payable by the Lottery Commission" to mean that all low-tier prizes should be redeemed by the retailer and that the Lottery Commission has no legal obligation to recover such unclaimed prizes.

Third, the Lottery has indicated that it believes that the recovery of unclaimed low-tier prizes would not be cost effective. Lottery staff have indicated that they believe that establishing the policies and procedures necessary to determine the extent of the unclaimed low-tier prizes and to recover the low-tier prizes from retailers would require an increase in the current 5 percent commission rate for Lottery retailers. Moreover, they state that it might result in an additional estimated cost of $2 million to $4 million per year in the Lottery's administrative expenses. Lottery staff have not been able to specifically identify costs associated with identifying and recovering such low-tier prizes and offer the above figures only as estimates.

The Little Hoover Commission is particularly concerned about this aspect of Lottery operations for several reasons. First, we are concerned that the Lottery does not know with any degree of certainty how much money is being retained by retailers due to unclaimed low-tier prizes. As previously noted, estimates of the prizes retained by retailers vary from $13.8 million to $34.6 million. Due to the potential sizable amount of funds, it makes good business sense to determine how much money the Lottery is allowing retailers to retain.

Next, the Commission is concerned about the practices of giving retailers a "hidden subsidy" by allowing them to retain unclaimed prizes. Retailer commissions should reflect the cost of doing business plus a reasonable profit. If the retailers in fact cannot meet the cost of selling Lottery tickets with the current 5 percent sales commission, then an adjustment may be in order. However, this adjustment should not be in the form of a "bonus" of some unknown size, paid from funds that are earmarked for public schools.

Finally, the Commission is concerned, not only for the unclaimed prizes already lost to the State's educational system, but even more for the increased amount of unclaimed prize revenue which may be lost in the future. The first eight instant ticket games, which ended October 30, 1986, included Lottery retailer payment to winners for the $2 and $5 prizes. Therefore, retailers could not retain any unclaimed prizes above these amounts. However, for the current game in progress through December 1986, and for the next game ending in February 1987, retailers are paying out prizes for winning $2, $5, and $10 tickets. In subsequent games, beginning in March 1987, retailers will be responsible for the payment of $20 winning tickets as well. Lottery officials have further indicated that they would like to have retailers validate and pay prizes up to $600 in future games. With the number and total amount of Lottery prizes payable by retailers increasing, these same retailers may have the capability to retain a larger and larger amount of unclaimed prizes in the future. This potentially could deny public education an increasing source of funds at the same time when California schools most need these funds.

FINDING #8 - The Lottery Has Not Made Timely or Complete Financial Reports Required by Law

Since the Lottery is exempt from normal oversight by other state control agencies, one of the primary means that was established by the Lottery Initiative to ensure public accountability for the Lottery's activities was the requirement that the Lottery prepare quarterly and monthly financial reports on its activities. During its first year of operation, the Lottery has not produced timely and complete financial reports. As a result, the Lottery has not fully adhered to the requirements for public disclosure and accountability that govern its operations.

The best and oftentimes the only indication of the continuing performance of the Lottery are the periodic financial reports issued by the Lottery. Section 8880.42 of the Government Code states that, "The Director shall make a monthly financial report to the Commission, the Governor, the Attorney General, the State Controller, the State Treasurer, and the Legislature. Such report shall include a full and complete statement of Lottery revenues, prize disbursements, expenses, net revenues, and other financial transactions for the month." These reports, along with the required annual audit by an independent certified public accounting firm that is required under Section 8880.43 of the Government Code are the primary means of reviewing the Lottery's financial condition and performance.

On several occassions, the officials at the Lottery have compared the Lottery's operations to those of a "Fortune 500" company. However, whether the Lottery is held to the standard identified in the Government Code, or to a similar standard of financial accountability used by publicly-held

corporations, the Lottery has failed to fully provide the timely and complete financial reporting necessary to adequately assess its financial condition and performance.

For example, the Lottery is required to issue detailed monthly financial reports which provide a point in time depiction of the Lottery's on-going financial operations. Since the Lottery began sales in October 1985, its monthly financial statements have routinely been issued late. For example, the statements for the months of October 1985 through April 1986 were not issued until May 1986. The next reports, for May and June 1986, were issued to the State Controller's Office in July 1986. The monthly reports for July through September were issued in late October 1986, and the October monthly report was received in early December. It is apparent from this pattern of issuing reports that the Lottery has not been providing monthly reports in a timely manner.

The State Controller's Office has raised some concerns regarding the clarity and completeness of the Lottery's monthly reports. The monthly reports contain only six items: net sales less returns; ticket costs; retailer commissions; prize liabilities; salaries and administrative expenses; and estimated net revenues. In those months where transfers to the Lottery Education Fund are made, such amounts are also reflected. The Lottery does not provide information regarding specific game costs or types of prizes paid, nor does it provide detail regarding expenditures for personnel, consultants, or any other administrative expenses. Moreover, the Lottery does not provide any information on physical inventory of tickets (an area of prior Lottery problems), nor any information on the reconciliation of Lottery records on Lottery cash and sales. Without such information, the monthly reports cannot be reconciled to the quarterly or annual statements. This lack of detail makes the monthly statements relatively useless for gauging the Lottery's performance over a specific period of time.

The Lottery has committed itself to delivering its independently reviewed quarterly reports within 45 days of the close of the quarter. However, for the four quarters of the Lottery's operation completed to date, only one quarterly statement of operations was submitted in this time frame. Other reports were submitted between 63 to 108 days after the close of the quarter. One report, for the last quarter of fiscal year 1985-86 was not submitted at all. Instead, it merged into the year-end report. The year-end financial statements were issued approximately 120 days after the close of the year, rather than the 90 days which is customarily the practice in the private sector. Moreover, the management letter which normally accompanies such yearly financial statements has still not been issued, six months after the close of the fiscal year.

The lack of timeliness and completeness in the financial reports has resulted in a general lack of accountability that has kept the Legislature, state control agencies, and the public somewhat "in the dark" about the Lottery's financial condition and performance.

FINDING #9 - The Lottery is Exempt from an Independent Annual Budgetary Review

The California State Lottery occupies a unique and unprecedented position as a state agency. Under the provisions of the Lottery Act, the Lottery is exempt from normal budgetary review by the Legislature and other state oversight and control agencies. Specifically, the Lottery does not undergo an annual independent budgetary review. Since the Lottery has grown substantially in a very short period of time, an annual budgetary review of the Lottery could provide greater assurance that the amount of funding being generated by the Lottery for education is being maximized.

Various sections of the Lottery Act specifically prohibit certain state control agencies from overseeing Lottery budgets and operations, including the Department of Finance, the Department of General Services, and the Office of Administrative Law. At the Little Hoover Commission's October 29, 1986 public hearing, a representative from the Legislative Analyst's Office stated that the Legislative Analyst's Office does not perform routine budgetary oversight and reviews of the Lottery as it does for most state agencies.

Presently, the Lottery's funds are considered as "non-governmental trust and agency funds" by the Department of Finance. Therefore, the Lottery's funds are exempt from the normal legislative budget and appropriations process. The Legislative Analyst had previously recommended that the Lottery's budget be reviewed in the Legislative budget and appropriations process. Control language to provide for such a review was placed in the fiscal year 1985-86 Budget Act that was passed by the Legislature. However, this control language was subsequently vetoed by the Governor.

An independent review of the Lottery's budget would provide two major advantages. First, since the Lottery is administered by a part-time Commission, it would provide a detailed independent review and oversight of the Lottery's day-to-day operations that is currently absent in the Lottery's budgetary process. Presently, the Governor, the Legislature, and the Lottery Commission do not have a mechanism in place to routinely review and critique the Lottery's budget plan and expenditures.

Second, because every dollar saved in Lottery administrative costs represents an additional dollar provided for the State's educational system, an independent review of the Lottery's budget would help ensure that the Lottery is operating in an economical manner and that the amount of funding being generated by the Lottery for education is being maximized.

The establishment of an independent budgetary review process for the Lottery would provide additional "sunshine" on the Lottery's budget plan and expenditures, improve the information base available to policy makers, and provide an increased level of assurance that the Lottery is conducting its activities in a fiscally responsible manner.

V. CONCLUSIONS AND RECOMMENDATIONS

This chapter briefly summarizes the conclusions of the review of the Lottery's organization, operation, and performance and presents the Little Hoover Commission's recommendations for addressing the problems identified.

CONCLUSIONS

The California State Lottery has grown rapidly in its first year of operation. The Lottery has done an excellent job of marketing and its sales have far exceeded initial expectations. Because of its rapid sales, the Lottery has already provided more than $800 million to the State's educational system.

The tremendous success of the Lottery in selling lottery tickets has placed considerable strain on the Lottery's staff to establish and operate what has become a $2 billion-a-year business. During the past year, the Lottery's staff has grown to more than 1,000 authorized staff positions and its administrative operating budget is now close to $70 million per year. In fact, the Lottery is now the State's 24th largest department.

Although the Lottery's staff has worked long and hard hours to accomplish as much as it has to date, the Lottery has not fully implemented the business systems, procedures and controls that are necessary in a business undertaking of the Lottery's magnitude. Our review of the Lottery indicated that some major areas of its operation warrant additional attention, including the Lottery's competitive bidding practices, its contract evaluation and appeals processes, its contract management system, and its unclaimed low-tier prizes handling practices. Moreover, the study provided additional information on key issues that are being examined by the Legislature and the Lottery Commission, including the business activities of the Lottery's contractors in South Africa and the minority business enterprise practices of the Lottery's contractors. Finally, the review indicated that there are other areas that should be further improved, such as the Lottery's financial reporting practices and its budget review process.

RECOMMENDATIONS

The Little Hoover Commission recommends that the Governor, the Legislature, and the Lottery take action to address the problems in the Lottery's organization, operation, and performance identified in this study. Specifically, the Little Hoover Commission recommends that the following actions be taken to ensure that the Lottery establishes adequate business systems and procedures necessary to provide sufficient financial accountability and control:

1. Require the Lottery to Utilize Competitive Bidding for Purchases of Goods and Services of $10,000 or More.

   The Governor and the Legislature should enact legislation that would require the Lottery to competitively bid purchases for goods and services in a manner that is consistent with the requirements for other state agencies. This should not include electronic data processing and

telecommunications purchases which have been previously addressed in legislation.

2. Require the Lottery to Determine if Goods and Services are Available Through the Department of General Services' Existing Contracts or Price Schedules Prior to Undertaking Any Procurement of $10,000 or More.

The Governor and the Legislature should enact legislation that would require the Lottery to make a determination if goods and services are available through contracts or state price schedules administered by the Department of General Services' Office of Procurement prior to the Lottery procurring items on its own.

3. Require the Lottery to Establish a Centrally Administered Contracts Management System

The Governor and the Legislature should require the Lottery to establish a central unit within the Lottery's operation that is responsible for managing its contracting activities, including contract development and preparation, authorization, performance monitoring, and payment.

4. Develop, Adopt, Use, and Maintain Consistent and Comprehensive Contracting Procedures

The Lottery should develop, adopt, use, and maintain a consistent and comprehensive set of procedures in its day-to-day operations. This will ensure uniform contracting practices by the various operational units within the Lottery.

5. Require the Lottery to Use the Guidelines in the State Administrative Manual in Preparing Requests for Proposals

The Governor and the Legislature should require the Lottery to use the guidelines in the State Administrative Manual in Preparing Requests for Proposals (RFPs). This will help ensure that the Lottery's RFPs meet the standards established for other state agencies.

6. Clarify and Improve the Request for Proposal Development and Proposal Evaluation Processes

The Lottery should work to further clarify and improve its Request for Proposal (RFP) development and evaluation process. This can be done by providing greater specificity in the Lottery's RFPs relating to the nature of the products and services it requires and more detailed information on how proposals will be evaluated and scored.

7. Require the Lottery to Use an Independent Review and Appeals Process to Resolve Contract Disputes

The Governor and the Legislature should require the Lottery to use an independent review and appeals process by a disinterested third party to resolve contract disputes. Specifically, the Lottery should be required to use the services of the State Board of Control to resolve contract protests from vendors that cannot be resolved by the Lottery Director to the satisfaction of all parties.

8. Review the Minority Business Enterprise Subcontract of the Current Instant Game Ticket Contractor

The Lottery Commission should conduct a thorough review of the minority business enterprise subcontract that Security Packaging, Inc. has with the Lottery's current instant game ticket contractor, Scientific Games, Inc. Specifically, the Lottery Commission should review the ownership, control and management of Security Packaging, Inc. to determine if it legally qualifies as a minority business enterprise and meets the Lottery Commission's requirements for minority business enterprise participation.

9. Review Scientific Games, Inc.'s Business Involvement in South Africa and the Statements that Scientific Games, Inc. Made Regarding its Business Involvement in South Africa to the Legislature

The Lottery Commission should review the information that Scientific Games, Inc. has provided regarding its business involvement in South Africa and the statements that it has made regarding such involvement to the Legislature. Specifically, the Lottery Commission should make a determination of whether Scientific Games, Inc. misrepresented its business involvement in South Africa before the Legislature in an attempt to secure a contract with the Lottery. In addition, the Lottery Commission should determine whether any grounds exist for terminating the existing instant game ticket contract with Scientific Games, Inc. based upon the representations it has made regarding its business involvement in South Africa.

10. Require the Lottery to Contract for an Independent Study of the Amount of Unclaimed Low-Tier Prizes and Determine if it is Economically Feasible and Practical to Develop a System to Recapture Lost Revenues from Unclaimed Low-Tier Prizes

The Governor and the Legislature should require the Lottery to contract with an independent firm for a study of the amount of unclaimed low-tier prizes currently retained by lottery ticket retailers. This study should determine the estimated number of unclaimed low-tier prizes and the potential amount of funding that the State's educational system loses due to the Lottery's current practice of allowing retailers to keep the proceeds from unclaimed low-tier prizes. In addition, the study should analyze the costs and benefits of various alternative systems to collect or adjust retailers ticket commissions for unclaimed low-tier prizes. Once the study is completed, the Lottery Commission should determine if it is economically feasible and practical to develop a system to recapture lost revenues from unclaimed low-tier prizes.

11. Require the Lottery to Provide More Timely and Complete Financial Reports

The Governor and the Legislature should enact legislation that requires the Lottery to issue monthly financial reports within 15 days after the

end of each month. They also should require the Lottery to issue quarterly financial reports within 45 days after the end of each quarter and issue annual financial statement within 90 days after year end. In addition, the Lottery should be required to provide more complete information on its monthly reports, including more complete information on game costs, detailed information on expenditures, and other administrative expenses.

12. Require Lottery Funds to be Subject to Legislative Review Through the State's Normal Budget Process

The Governor and the Legislature should require that all Lottery funds be classified by the Department of Finance as special funds that are contingent on a direct Budget Act appropriation. This would ensure that Lottery-related expenditures are properly tracked, and are subject to an annual budgetary review by the Legislative Analyst's Office.

APPENDIX A

CALIFORNIA STATE LOTTERY ACT
CALIFORNIA GOVERNMENT CODE, TITLE 2, DIVISION 1
CHAPTER 12.5

CALIFORNIA STATE LOTTERY ACT
(California Government Code, Title 2, Division 1, Chapter 12.5)

ARTICLE 1

General Provisions and Definitions

Section 8880 Citation of Chapter

This Chapter shall be known and may be cited as the California State Lottery Act of 1984.

Section 8880.1 Purpose and Intent

The People of the State of California declare that the purpose of this Act is support for preservation of the rights, liberties, and welfare of the people by providing additional monies to benefit education without the imposition of additional or increased taxes.

The People of the State of California further declare that it is their intent that the net revenues of the California State Lottery shall not be used as substitute funds but rather shall supplement the total amount of money allocated for public education in California.

Section 8880.2 Activities Not Affected

Except for the State-operated Lottery established by this Chapter, nothing in this Chapter shall be construed to repeal or modify existing State law with respect to the prohibition of casino gambling, punch boards, slot machines, dog racing, video poker or blackjack machines paying prizes, or any other forms of gambling.

Section 8880.3 Prohibition on Use of State Funds

No appropriations, loans, or other transfer of State funds shall be made to the California State Lottery Commission except for a temporary line of credit for initial start-up costs as provided in this Act.

Section 8880.4 Allocation of Revenues

Not less than 84% of the total annual revenues from the sale of State lottery tickets or shares shall be returned to the public in the form of prizes and net revenues to benefit public education. 50% of the total annual revenues shall be returned to the public in the form of prizes as described in this Chapter and at least 34% shall be allocated to the benefit of public education as specified in Section 8880.5. In addition, all unclaimed prize money shall revert to the benefit of public education as provided for in Section 8880.32(e). No more than 16% of the total annual revenues shall be allocated for payment of expenses of the Lottery as described in this Chapter. To the extent that expenses of the Lottery are less than 16% of the total annual revenues, any surplus funds shall also be allocated to the benefit of public education as specified in Section 8880.5.

Section 8880.5 Allocations for Education

The California State Lottery Education Fund is created within the State Treasury, and is continuously appropriated for carrying out the purposes of this Chapter. The Controller shall draw warrants on this fund and distribute them quarterly in the following manner, provided that the payments specified in subdivisions (a) to (f), inclusive, shall be equal per capita amounts:

(a) Payments shall be made directly to public school districts, including county superintendents of schools, serving grades kindergarten through 12, or any part thereof, on the basis of an equal amount for each unit of average daily attendance, as defined by law.

(b) Payments shall also be made directly to public school districts serving community colleges, on the basis of an equal amount for each unit of average daily attendance, as defined by law.

(c) Payments shall also be made directly to the Board of Trustees of the California State University on the basis of an amount for each unit of equivalent full-time enrollment. Funds received by the trustees shall be deposited in and expended from the California State University Lottery Education Fund which is hereby created.

(d) Payments shall also be made directly to the Regents of the University of California on the basis of an amount for each unit of equivalent full-time enrollment.

(e) Payments shall also be made directly to the Board of Directors of the Hastings College of the Law on the basis of an amount for each unit of equivalent full-time enrollment.

(f) Payments shall also be made directly to the California Maritime Academy Board of Governors on the basis of an amount for each unit of equivalent full-time enrollment.

(g) No Budget Act or other statutory provision shall direct that payments for public education made pursuant to this chapter be used for purposes and programs (including workload adjustments and maintenance of the level of service) authorized by Chapters 498, 565, and 1302 of the Statutes of 1983, Chapter 97 or 258 of the Statutes of 1984, or Chapter 1 of the Statutes of 1984, 2nd Extraordinary Session.

(h) School districts and other agencies receiving funds distributed pursuant to this chapter may at their option utilize funds allocated by this chapter to provide additional funds for those purposes and programs prescribed by subdivision (g) for the purpose of enrichment or expansion.

(i) As a condition of receiving any moneys pursuant to subdivision (a) or (b), each district and county superintendent of schools shall establish a separate account for the receipt and expenditure of those moneys, which account shall be clearly identified as a lottery education account.

It is the intent of this Chapter that all funds allocated from the California State Lottery Education Fund shall be used exclusively for the education of

pupils and students and no funds shall be spent for acquisition of real property, construction of facilities, financing of research, or any other noninstructional purpose.

Section 8880.6 Other Statutory Provision

It is specifically found that Penal Code Sections 320, 321, 322, 323, 324, 325, 326, and 328 shall not apply to the California State Lottery or its operations.

Section 8880.7 Governing Definitions

The definitions contained in this Chapter shall govern the construction of this Chapter unless the context requires otherwise.

Section 8880.8 "Lottery" or "California State Lottery"

"Lottery" or "California State Lottery" means the California State Lottery created and operated pursuant to this Chapter.

Section 8880.9 "Commissioner"

"Commissioner" means one of the members of the Lottery Commission appointed by the Governor pursuant to this Chapter to oversee the California State Lottery.

Section 8880.10 "Director"

"Director" means the Director of the California State Lottery appointed by the Governor pursuant to this Chapter as the chief administrator of the California State Lottery.

Section 8880.11 "Lottery Commission" or "Commission"

"Lottery Commission" or "Commission" means the five members appointed by the Governor pursuant to this Chapter to oversee the Lottery and the Director.

Section 8880.12 "Lottery Game"

"Lottery Game" means any procedure authorized by the Commission whereby prizes are distributed among persons who have paid, or unconditionally agreed to pay, for tickets or shares which provide the opportunity to win such prizes.

Section 8880.13 "Lottery Game Retailer"

"Lottery Game Retailer" means a person or organization with whom the Lottery Commission may contract for the purpose of selling tickets or shares in Lottery Games to the public.

Section 8880.14 "Lottery Contractor"

"Lottery Contractor" means a person with whom the Lottery has contracted for the purpose of providing goods and services required by the Lottery.

ARTICLE 2

California State Lottery Commission

Section 8880.15 Creation of Commission

The California State Lottery Commission is hereby created in State government.

Section 8880.16 Membership, Appointment, Vacancies, Political Affiliation, Removal

(a) The Commission shall consist of five members appointed by the Governor with the advice and consent of the Senate.

(b) The members shall be appointed for terms of five years, except for those who are first appointed, one member shall be appointed for a term of two years, one member shall be appointed for a term of three years, one member shall be appointed for a term of four years, and two members shall be appointed for a term of five years.

(c) All initial appointments shall be made within 30 days of the effective date of this Chapter.

(d) Vacancies shall be filled within 30 days by the Governor, subject to the advice and consent of the Senate, for the unexpired portion of the term in which they occur.

(e) No more than three members of the Commission shall be members of the same political party.

(f) The Governor may remove any Commissioner upon notification to the Commission and the Secretary of State.

Section 8880.17 Qualifications of Commissioners

At least one of the Commissioners shall have a minimum of five years experience in law enforcement, and at least one of the Commissioners shall be a certified public accountant.

Section 8880.18 Compensation and Expenses

Commissioners shall be compensated at the rate of one hundred dollars ($100) for each day they are engaged in Commission business. Commission members shall be reimbursed for actual expenses incurred on Commission business, including necessary travel expenses as determined by the Department of Personnel Administration.

Section 8880.19 Annual Selection of Chairperson

The Commission shall select annually from its membership a Chairperson. The Chairperson shall have the power to convene special meetings of the Commission upon 48-hours written notice to members of the Commission.

Section 8880.20 Meetings

Meetings of the Commission shall be open and public in accordance with the Bagley-Keene Open Meeting Act, commencing with Section 11120 of Chapter 1 or Part 1 of Division of this title.

Section 8880.21 Quorum; Voting

A quorum shall consist of three members of the Commission. All decisions of the Commission shall be made by a majority vote of the Commission.

Section 8880.22 Reports

The Commission shall make quarterly reports of the operation of the Lottery to the Governor, Attorney General, State Controller, State Treasurer, and the Legislature. Such reports shall include a full and complete statement of Lottery revenues, prize disbursements, expenses, net revenues, and all other financial transactions involving Lottery funds.

Section 8880.23 Appointment of Director, Removal

The Governor, with the advice and consent of the Senate, shall appoint a Director within thirty days of the effective day of this Chapter. The Governor may remove the Director upon notification to the Commission and the Secretary of State. The Director shall be responsible for managing the affairs of the Commission. The Director shall be qualified by training and experience to direct the operations of a state-operated Lottery.

ARTICLE 3

Powers and Duties of the Commission

Section 8880.24 Powers and Duties of the Commission

The Commission shall exercise all powers necessary to effectuate the purposes of this Chapter. In all decisions, the Commission shall take into account the particularly sensitive nature of the California State Lottery and shall act to promote and ensure integrity, security, honesty, and fairness in the operation and administration of the Lottery.

Section 8880.25 Initiation and Operation of the Lottery

The Commission shall initiate operation of the Lottery on a continuous basis at the earliest feasible and practical time. Public sales of tickets or shares shall begin no later than 135 days after the effective date of this Chapter. The Lottery shall be initiated and operated as to produce the maximum amount of net revenues to benefit the public purpose described in this Chapter.

Section 8880.26 Exemption from Review by the Office of Administrative Law

The provisions of Chapter 3.5 of Part 1 of Division 3 of Title 2 of the Government Code shall not be applicable to any rule or regulation promulgated by the Commission in accordance with the provisions of this Chapter.

Section 8880.27 Meetings with the Director

The Commission shall meet with the Director not less than once each quarter to make recommendations and set policy, to approve or reject reports of the Director and transact such other business that may be properly brought before it.

Section 8880.28 Limitations on Types of Lottery Games

The Commission shall promulgate rules and regulations specifying the types of Lottery Games to be conducted by the Lottery, provided:

(a) No Lottery Game may use the theme of bingo, roulette, dice, baccarat, blackjack, Lucky 7s, draw poker, slot machines, dog racing, or horse racing.

(b) In Lottery Games utilizing tickets, each ticket in such games shall bear a unique number distinguishing it from every other ticket in such game; and no name of an elected official shall appear on such tickets.

(c) In games utilizing computer terminals or other devices, no coins or currency shall be dispensed to players from such computer terminals or devices.

Section 8880.29 Number and Value of Prizes

(a) The Commission shall promulgate rules and regulations which specify the number and value of prizes for winning tickets or shares in each Lottery Game including, without limitation, cash prizes, merchandise prizes, prizes consisting of deferred payments or annuities, and prizes of tickets or shares in the same Lottery Game or other games conducted by the Lottery, provided:

(1) In Lottery Games utilizing tickets, the overall estimated odds of winning some prize or some cash prize as appropriate for the Lottery Game shall be printed on each ticket.

(2) A detailed tabulation of the estimated number of prizes of each particular prize denomination that are expected to be awarded in each Lottery Game, or the estimated odds of winning the prizes, shall be available at each location at which tickets or shares in such Lottery Games are offered for sale to the public.

(b) Annuity contracts which are purchased for prizes shall be exempt from the requirements of Section 8880.57.

Section 8880.30 Method of Determining Winners

The Commission shall promulgate rules and regulations which specify the method for determining winners in each Lottery Game, provided:

(a) No Lottery Game shall be based on the results of a horse race.

(b) If a Lottery Game utilizes a drawing of winning numbers, a drawing among entries, or a a drawing among finalists, such drawings shall always be open to the public; such drawings shall not be conducted by any employee of the Lottery; such drawings shall be witnessed by an independent certified public accountant; any equipment used in such drawings must be inspected by the independent certified public account and an employee of the Lottery both before and after such drawings; and such drawings and such inspections shall be recorded on both video and audio tape.

(c) It is the intent of this Chapter that the Commission may use any of a variety of existing or future methods or technologies in determining winners.

Section 8880.31 Sale Price of Tickets and Shares

The Commission shall promulgate rules and regulations specifying the retail sales price for each ticket or share for each Lottery Game, provided:

(a) No ticket or share shall be sold for more than the retail sales price established by the Commission.

(b) The retail price of each ticket or share in any Lottery Game conducted by the Lottery shall be at least one dollar, except to the extent of any discounts authorized by the Commission.

Section 8880.32 Validation and Payment of Prizes

The Commission shall promulgate rules and regulations to establish a system of verifying the validity of prizes and to effect payment of such prizes, provided:

(a) For convenience of the public, Lottery Game Retailers may be authorized by the Commission to pay winners of up to six hundred dollars ($600) after performing validation procedures on their premises appropriate to the Lottery Game involved.

(b) No prize may be paid arising from tickets or shares that are stolen, counterfeit, altered, fraudulent, unissued, produced or issued in error, unreadable, not received or not recorded by the Lottery by applicable deadlines, lacking in captions that confirm and agree with the lottery play symbols required by the Lottery Game involved, purchased by a minor, or not in compliance with such additional specific rules and regulations and confidential validation and security tests appropriate to the particular Lottery Game.

(c) No particular prize in any Lottery Game may be paid more than once, and in the event the Commission reaches a binding determination that more than one claimant is entitled to a particular prize, the sole remedy of the claimants is the award to each of them of an equal share in the prize

and the Commission shall direct the Controller to disburse the award to the claimants in equal shares.

(d) The Commission may specify that winners of less than twenty-five dollars ($25) claim the prizes from either the same Lottery Game Retailer from whom it was purchased or from the Lottery itself.

(e) Players shall have the right to claim prize money for 180 days after the drawing or the end of the Lottery game or play in which the prize was won. The Commission may define shorter time periods for eligibility for participation in, and entry into, drawings involving entries or finalists. If a valid claim is not made for a prize directly payable by the Lottery Commission within the period applicable for that prize, the unclaimed prize money shall revert to the benefit of the public purpose described in this Chapter.

(f) After the expiration of the claim period for prizes for each Lottery Game, the Commission shall make available a detailed tabulation of the total number of tickets or shares actually sold in a Lottery Game and the total number of prizes of each prize denomination that were actually claimed and paid directly by the Lottery Commission.

(g) The right of any person to a prize shall not be assignable, except that payment of any prize may be paid to the estate of a deceased prize winner or to a person designated pursuant to an appropriate judicial order. In the event there is no probate, the prize shall be distributed in accordance with Section 21211. The Director, Commission, and the State shall be discharged of all further liability upon such payment of a prize pursuant to this subsection.

(h) A ticket or share shall not be purchased by, and a prize shall not be paid to, a member of the Commission or to any officer or employee of the Commission or to any spouse, child, brother, sister, or parent of that person. Any person who knowingly sells or purchases a ticket or share in violation of this section, or who knowingly claims or attempts to claim a prize with a ticket or share that was purchased or sold in violation of this section, is guilty of a misdemeanor.

(i) No prize shall be paid to any person under the age of 18. Any person who claims or attempts to claim a prize with a ticket or share purchased by a person under the age of 18 is guilty of a misdemeanor.

Section 8880.33 Distribution of Tickets and Shares

The Commission shall promulgate rules and regulations specifying the manner of distribution, dissemination, or sales of lottery tickets or shares to Lottery Game Retailers or directly to the public, and the incentives, if any, for Lottery employees, if any, engaged in such distribution activities.

ARTICLE 4

Powers and Duties of the Director

Section 8880.34 Salary

The Director shall be compensated at the rate determined by the Department of Personnel Administration. The Director shall devote his or her entire time and attention to the duties of his or her office and shall not be engaged in any other profession or occupation.

Section 8880.35 Duties, Powers, and Jurisdiction

The Director shall, subject to the approval of the Commission, perform all duties, exercise all powers and jurisdiction, assume and discharge all responsibilities, and carry out and effect all purposes of this Chapter. The Director shall act as Secretary of the Commission and Executive Officer of the Lottery. The Director shall supervise and administer the operation of the Lottery in accordance with this Chapter and the rules and regulations promulgated by the Commission. In addition, the Director shall have access to criminal history information pursuant to Sections 11105 and 11105.01 of the Penal Code. In all decisions, the Director shall take into account the particularly sensitive nature of the California State Lottery and shall act to promote and ensure integrity, security, honesty, and fairness of the operation and administration of the Lottery.

Section 8880.36 Power to Hire

The Director shall hire, pursuant to the approval of the Commission, such professional, clerical, technical, and administrative personnel as may be necessary to carry out the provisions of this Chapter.

Section 8880.37 Deputy Directors

Upon recommendation of the Director, the Governor shall appoint up to four deputy directors. The Director shall supervise each deputy director's activities. The Commission shall determine the compensation of each deputy director.

Section 8880.38 Deputy Director for Security

One of the deputy directors shall be responsible for a security division to assure integrity, honesty, and fairness in the operation and administration of the California State Lottery, including but not limited to, an examination of the qualifications of all prospective employees, Lottery Game Retailers, and Lottery suppliers as defined in Section 8880.57. The Deputy Director for Security shall be qualified by training and experience, including at least five years of law enforcement experience, and shall have knowledge and experience in computer security, to fulfill these responsibilities. The Deputy Director for Security shall confer with the Attorney General or his designee and the Controller or his or her designee as the Deputy Director for Security deems necessary and advisable to promote and ensure integrity, security, honesty, and fairness of the operation and administration of the Lottery. The Deputy Director for Security shall report any alleged violation

of law related to the operations of the California State Lottery to the appropriate law enforcement agency and the Attorney General for further investigation and action. The Deputy Director for Security and lottery security officers shall have access to criminal history information pursuant to Sections 11105 and 11105.01 of the Penal Code.

Section 8880.39 Coordination with Commission

The Director shall confer as frequently as necessary or desirable, but not less than once every quarter, with the Commission, on the operation and administration of the Lottery. The Director shall make available for inspection by the Commission, upon request, all books, records, files, and other information and documents of the Lottery, advise the Commission and recommend such matters as he deems necessary and advisable to improve the operation and administration of the Lottery.

Section 8880.40 Study of Lottery Systems; Recommendations for Improvement

The Director shall make an on-going study of the operation and the administration of the lotteries which may be in operation in other states or countries, of available literature on the subject, of Federal laws which may affect the operation of the Lottery, and of the reaction of citizens of the State to existing or proposed features in Lottery Games, with a view toward recommending improvements that will tend to serve the purposes of this Chapter. The Director may make recommendations to the Commission, Governor, and Legislature on any matters concerning the secure and efficient operation and administration of the Lottery and the convenience of the purchasers of tickets and shares.

Section 8880.41 Accountability; Books and Records

The Director shall make and keep books and records which accurately and fairly reflect each day's transactions, including but not limited to, the distribution of tickets or shares to Lottery Game Retailers, receipt of funds, prize claims, prize disbursements or prizes liable to be paid, expenses and other financial transactions of the Lottery necessary so as to permit preparation of daily financial statements in conformity with generally accepted accounting principles and maintain accountability.

Section 8880.42 Monthly Financial Reports

The Director shall make a monthly financial report to the Commission, the Governor, the Attorney General, the State Controller, the State Treasurer, and the Legislature. Such report shall include a full and complete statement of Lottery revenues, prize disbursements, expenses, net revenues, and other financial transactions for the month.

Section 8880.43 Independent Audit of Lottery Finances

The Director shall engage an independent firm of certified public accountants to conduct an annual audit of all accounts and transactions of the Lottery. The audit report shall be presented to the Commission, the Governor, the Controller, the Treasurer, the Attorney General and the Legislature.

Section 8880.44 Demographic Study of Lottery Players

After the first six months of sales to the public, the Director shall engage an independent firm experienced in demographic analysis to conduct a special study which shall ascertain the demographic characteristics of the players of each Lottery Game, including but not limited to their income, age, sex, education, and frequency of participation. This report shall be presented to the Commission, the Governor, the State Controller, the State Treasurer, and the Legislature. Similar studies shall be conducted from time to time as determined by the Director.

Section 8880.45 Study of the Effectiveness of Lottery Communications

After the first full year of sales to the public, the Director shall engage in independent firm experienced in the analysis of advertising, promotion, public relations, incentives, and other aspects of communications to conduct a special study of the effectiveness of such communications activities and make recommendations to the Commission on the future conduct and future rate of expenditure for such activities. This report shall be presented to the Commission, the Governor, the State Controller, and the State Treasurer. Until the presentation of such report and action by the Commission, the Commission shall expend as close to 3-1/2% as practical of the projected sales of all lottery tickets and shares for advertising, promotion, public relations, incentives, and other aspects of communications. Similar studies shall be conducted from time to time after the first such study as determined by the Director.

Section 8880.46 Independent Audit of Lottery Security

After the first nine months of sales to the public, the Commission shall engage an independent firm experienced in security procedures, including but not limited to computer security and systems security, to conduct a comprehensive study and evaluation of all aspects of security in the operation of the Lottery. This study shall include, but not be limited to, personnel security, Lottery Game Retailer security, Lottery Contractors security, security of manufacturing operations of Lottery Contractors, security against ticket counterfeiting and alterations and other means of fraudulently winning, security of drawings, computer security, data communications security, database security, systems security, lottery premises and warehouse security, security in distribution, security involving validation and payment procedures, security involving unclaimed prizes, security aspects applicable to each particular Lottery Game, security against locating winners in Lottery Games having pre-printed winners, and any other aspects of security applicable to the Lottery and its operations. The portion of the report containing the overall evaluation of the Lottery in terms of each aspect of security shall be presented to the Commission, the Governor, the Controller, the Treasurer, the Attorney General and the Legislature. The portion of the report containing specific recommendations shall be exempt from public disclosure and shall be presented only to the Commission, the Attorney General, the Controller and the Governor. Upon request, all materials and data used in the production of the report shall be made available to the Commission, the Attorney General, the Controller and the Governor. Similar audits of security shall be conducted biannually thereafter.

ARTICLE 5

Lottery Game Retailers

Section 8880.47 Contracting with Lottery Game Retailers

The Commission shall promulgate rules and regulations specifying the terms and conditions for contracting with Lottery Game Retailers so as to provide adequate and convenient availability of tickets or shares to prospective buyers of each Lottery Game as appropriate for each such game.

Section 8880.48 Selection of Lottery Game Retailers

(a) The Director shall, pursuant to this Chapter and the rules and regulations of the Commission, select as Lottery Game retailer such persons and organizations as the Director deems shall best serve the public convenience and promote the sale of tickets or shares. No person under the age of 18 years shall be a Lottery Game Retailer. In the selection of Lottery Game Retailers, the Director shall consider factors such as financial responsibility, integrity, reputation, accessibility of the place of business or activity to the public, security of the premises, the sufficiency of existing Lottery Game Retailers to serve the public convenience, and the projected volume of the sales for the Lottery Game involved.

(b) In order to allow an evaluation of competence, integrity and character of potential Lottery Game Retailers, the Commission may require the information it deems necessary of any person, corporation, trust, association, partnership or joint venture applying for authority to act as a Lottery Game Retailer.

No person shall be a Lottery Game Retailer who is engaged exclusively in the business of selling lottery tickets or shares. A person lawfully engaged in nongovernmental business on State property and an owner or lessee of an establishment which sells alcoholic beverages and civic and fraternal organizations may be selected as a Lottery Game Retailer. The Director may contract with Lottery Game Retailers on a seasonal or temporary basis.

(c) The Commission shall establish a formal written appeal process concerning the denial of an application for, or revocation of, a grant of authority to be a Lottery Game Retailer.

Section 8880.49 Nonassignability

The authority to act as a Lottery Game Retailer shall not be assignable or transferable.

Section 8880.50 Termination of Lottery Game Retailer

(a) The Commission shall promulgate rules and regulations which shall prescribe the procedure by which a contract with a Lottery Game Retailer may be terminated and the reasons for the termination, including, but not

limited to, instances where a Lottery Game Retailer knowingly sells a ticket or share to any person under the age of 18.

(b) Any Lottery Game Retailer who employs or uses the services of any person under the age of 18 years for the sale of lottery tickets or shares shall be subject to the suspension or revocation of his or her license. However, a person under the age of 18 years may be employed or used to sell lottery tickets or shares, if that person is under the continuous supervision of a person 21 years of age or older.

Section 8880.51 Compensation for Lottery Game Retailers

Unless the Commission shall otherwise determine, the compensation paid to Lottery Game Retailers shall be a minimum of 5 percent of the retail prize of tickets or shares. In addition, an incentive bonus may be paid to such Lottery Game Retailers based on attainment of sales volume or other objectives as specified by the Director for each Lottery Game. In the case of a Lottery Game Retailer whose rental payments for his premises are contractually computed, in whole or in part, on the basis of a percentage of his retail sales, and where such computation of his retail sales is not explicitly defined to include sales of tickets or shares in a state-operated lottery, the compensation received by the Lottery Game Retailer from the Lottery shall be deemed as the amount of the retail sales for purposes of computing his rental payment.

Section 8880.52 Sales to Minors

(a) No tickets or shares in Lottery Games shall be sold to persons under the age of 18 years. Any person who knowingly sells a ticket or share in a Lottery Game to a person under the age of 18 years is guilty of a misdemeanor. Any person under the age of 18 years who buys a ticket for share in a Lottery is guilty of a misdemeanor. In the case of lottery tickets or shares sold by Lottery Game Retailers or their employees, these persons shall establish safeguards to assure that such sales are not made to persons under the age of 18 years. In the case of the dispensing of tickets or shares by vending machines or other devices, the Commission shall establish safeguards to help assure that the vending machines or devices are not operated by persons under the age of 18 years.

(b) All tickets or shares in Lottery Games shall include, and any devices which dispense tickets or shares in Lottery Games shall have posted in a conspicuous place thereupon, a notice which declares that State law prohibits the selling of a lottery ticket or share to, and the payment of any prize to, a person under the age of 18 years.

Section 8880.53 Display of Certificate of Authority

No lottery tickets or shares shall be sold by a Lottery Game Retailer unless he has his certificate of authority to sell lottery tickets or shares on display on his premises.

Section 8880.54 Bonding

The Director may require a bond from any Lottery Game Retailer in an amount specified by regulation or may purchase blanket bonds covering the activities of selected Lottery Game Retailers. These bonds shall be payable upon order of the Commission.

Section 8880.55 Lottery Game Retailer Payments

No payment by Lottery Game Retailers to the Lottery for tickets or shares shall be in cash. All such payments shall be in the form of a check, bank draft, electronic fund transfer, or other recorded financial instrument as determined by the Director.

ARTICLE 6

Lottery Suppliers

Section 8880.56 Procurement

(a) Notwithstanding other provisions of law, the Director may purchase or lease such goods and services as are necessary for effectuating the purposes of this chapter. The Director may not contract with any private party for the operation and administration of the California State Lottery created by this chapter. However, this section does not preclude procurements which integrate functions such as game design, supply, advertising, and public relations. In all procurement decisions, the Commission and Director shall take into account the particularly sensitive nature of the California State Lottery and shall act to promote and ensure integrity, security, honesty, and fairness in the operation and administration of the Lottery and the objective of raising net revenues for the benefit of the public purpose described in this chapter.

(b) Notwithstanding any other provisions of this chapter, the following shall apply to procurement for or by the Commission:

(1) With respect to the procurement for the printing of lottery tickets or the acquisition of any electronic computer, including any software used in conjunction therewith, the Commission shall adopt and publish competitive bidding procedures for the award of any procurement or contract in order to assure the fullest competition of the procurement. These procedures shall include a bid protest procedure.

(2) The provisions of Article I (commencing with Section 11250) of Chapter 3 of Part 1 of Division 3 apply to the Commission.

(3) The Commission is subject to the Small Business Procurement and Contract Act, as provided in Chapter 6.5 (commencing with Section 14835) of Part 5.5 of Division 3.

(4) In advertising or awarding any contract for the procurement of goods and services exceeding five hundred thousand dollars ($500,000), the Commission and the Director shall require all bidders or contractors, or both, to include specific plans or arrangements to utilize subcontracts with socially or economically disadvantaged small business concerns. The plans shall specifically identify the feasibility of utilizing the subcontract services, delineate the nature and extent of the services to be utilized, and those concerns or individuals identified for subcontracting if known.

It is the intention of the Legislature in enacting this section to establish as an objective of the utmost importance the advancement of business opportunities for these small business concerns in the private business activities created by the California State Lottery. In that regard, the Commission and the Director shall have an affirmative duty to achieve the most feasible and practicable level of participation by socially or economically disadvantaged small business concerns in its procurement programs.

By July 1, 1986, the Commission shall adopt proposal evaluation procedures, criteria, and contract terms which are consistent with the advancement of business opportunities for small business concerns in the private business activities created by the California State Lottery and which will achieve the most feasible and practicable level of participation by socially, economically and disadvantaged small business concerns in its procurement programs. The proposal evaluation procedures, criteria, and contract terms adopted shall be reported in writing to both houses of the Legislature on or before July 1, 1986.

For the purposes of this section, socially and economically disadvantaged persons include women, Black Americans, Hispanic Americans, Native Americans (including American Indians, Eskimos, Aleuts, and Native Hawaiians), Asian-Pacific Americans (including persons whose origins are from Japan, China, the Philippines, Vietnam, Korea, Samoa, Guam, the United States Trust Territories of the Pacific, Northern Marianas, Laos, Cambodia, and Taiwan), and other minorities or any other natural persons found by the Commission to be disadvantaged.

(5) The Commission shall report to the Legislature by July 1, 1987, on the level of participation of small businesses, economically and socially disadvantaged businesses, and California businesses in all contracts awarded by the Commission.

(6) The Lottery shall fully comply with the requirements of paragraphs (2), (3) and (4) except that any function or role which is otherwise the responsibility of the Department of Finance or the Department of General Services shall instead, for purposes of this subdivision, be the sole responsibility of the Lottery, which shall have the sole authority to perform that function or role.

Section 8880.57 Disclosures

In order to allow an evaluation of the competence, integrity, and character of potential Lottery Contractors for the California State Lottery, any person, corporation, trust, association, partnership or joint venture which submits a bid, proposal, or offer as part of procurement for a contract for any goods or services for the California State Lottery, other than materials, supplies, services, and equipment which are common to the ordinary operations of state agencies, shall comply with each of the following:

(a) At the time of submission of the bid, proposal, or offer to the Lottery, disclose the bidder's name and address and, as applicable, the name and address of the following:

(1) If the bidder is a corporation, the officers, directors, and each owner, directly or indirectly, of any equity security or other ownership interest in the corporation. However, in the case of owners of publicly held equity securities of a publicly traded corporation, only the names and addresses of those known to the corporation to beneficially own 5 percent or more of the publicly held securities need be disclosed.

(2) If the bidder is a trust, the trustee and all persons entitled to receive income or benefit from the trust.

(3) If the bidder is an association, the members, officers, and directors.

(4) If the bidder is a subsidiary, the officers, directors, and stockholders of the parent company thereof. However, in the case of owners of publicly held equity securities of a publicly traded corporation, only the names and addresses of those known to the corporation to beneficially own 5 percent or more of the publicly held securities need be disclosed.

(5) If the bidder is a partnership or joint venture, all of the general partners, limited partners, or joint venturers.

(6) If the parent company, general partner, limited partner, or joint venture of any bidder is itself a corporation, trust, association, subsidiary, partnership, or joint venture, then the disclosure of such information as necessary to determine ultimate ownership. However, in the case of owners of publicly held equity securities of a publicly traded corporation, only the names and addresses of those known to the corporation to beneficially own 5 percent or more of the publicly held securities need be disclosed.

(7) If the bidder proposes to subcontract any substantial portion of the work to be performed to a subcontractor, then all of the information required in this section shall be disclosed for the subcontractor as if it were itself a bidder.

(b) After receipt of a bid, proposal, or offer, but prior to the award of a contract, the Commission may require a potential Lottery Contractor to provide any or all of the following information:

(1) A disclosure of all the states and jurisdictions in which the bidder does business, and the nature of that business for each state or jurisdiction.

(2) A disclosure of all the states and jurisdictions in which the bidder has contracts to supply gaming goods or services, including, but not limited to, lottery goods and services, and the nature of the goods or services involved for each state or jurisdiction.

(3) A disclosure of all the states and jurisdictions in which the bidder has applied for, has sought renewal of, has received, has been denied, has pending, or has had revoked a gaming license of any kind, and the disposition in each state or jurisdiction. If any gaming license has not been renewed or any gaming license application has been either denied or has remained pending for more than six months, all of the facts and circumstances underlying this failure to receive a gaming license shall be disclosed.

(4) A disclosure of the details of any conviction or judgment of a state or federal court against the bidder of any gambling-related offense, or criminal offense other than traffic violations.

(5) A disclosure of the details of any bankruptcy, insolvency, or reorganization, or any judgment or pending litigation involving fraud or deceit against the bidder.

(6) A disclosure for each bidder who is a natural person of his or her employment, residence, educational, and military history since the age of 18 years.

(7) A disclosure consolidating all reportable information on all reportable contributions by the bidder to any local, state, or federal political candidate or political committee in this state for the past five years that is reportable under any existing state or federal law.

(8) A disclosure of the identity of any entity with which the bidder has a joint venture or other contractual arrangement to supply any state or jurisdiction with gaming goods or services, including, but not limited to, lottery goods or services; including a disclosure with regard to the entity of all of the information requested under paragraphs (1) to (8), inclusive.

(9) In the instance of a procurement for the printing of lottery tickets, for goods or services involving the receiving or recording of number selections, or for goods or services involving the determination of winners, an additional disclosure consisting of the individual federal and state income tax returns for the past three years and a current individual financial statement for each bidder who is a natural person. The disclosures provided in this paragraph shall be considered confidential and shall be transmitted directly to the Deputy Director for Security and the Attorney General for their review.

(10) Such additional disclosures and information as may be appropriate for the procurement involved as determined by the Commission.

(c) With respect to the persons or entities described in paragraphs (1) to (7), inclusive, of subdivision (a), the Commission may request the

disclosure of any information required in subdivision (b), which shall be relevant to the award of any contract.

(d) No contract with any bidder who has not complied with the disclosure requirements described in this section shall be entered into or be enforceable. Any contract with any Lottery Contractor who does not comply with these requirements for maintaining the currency of the disclosures during the term of the contract as may be specified in the contract may be terminated by the Commission. In addition, the Commission may deny or cancel a contract with a Lottery Contractor or any of the persons or entities included in paragraphs (1) to (7), inclusive, of subdivision (a) if any of the following apply:

(1) False statements have been made in any information which is required under this section.

(2) Any of the persons or entities have been convicted of a crime punishable as a felony.

(3) Any of the persons or entities have been convicted of an offense involving dishonesty or any gambling-related offense.

(e) This section shall be construed broadly and liberally to achieve the end of full disclosure of all information necessary to allow for a full and complete evaluation of the competence, integrity, and character of potential suppliers of the California State Lottery Commission.

Section 8880.58 Compliance with Applicable Laws

Each Lottery Contractor shall perform its contract consistent with the laws of this State, Federal law, and laws of the state or states in which such supplier is performing or producing, in whole or in part, any of the goods or services contract for hereunder.

Section 8880.59 Performance Bond

Each Lottery Contractor shall post a performance bond with the Commission, using a surety acceptable to the Commission, in an amount equal to the full amount estimated to be paid annually to the supplier under the contract. The Commission may require any Lottery Game Retailer to provide a fidelity bond which shall be payable upon order of the Commission.

Section 8880.60 Contracts

Subject to the approval of the Commission, the Director may directly solicit proposals or enter into contracts for the purchase or lease of goods or services for effectuating the purpose of this Chapter. In awarding contracts in response to solicitations for proposals conducted by the California State Lottery, the Director shall award such contracts to the responsible supplier submitting the lowest and best proposal pursuant to the procedures adopted by the Commission as prescribed in subdivision (b) of Section 8880.56, which maximizes the benefits to the state in relation to cost in the areas of security, competence, experience, timely performance, and maximization of net revenues to benefit the public purpose described in this Chapter. All

contracts entered into by the Director shall be subject to the approval of the Commission.

ARTICLE 7

State Lottery Fund

Section 8880.61 State Lottery Fund

(a) A special fund to be known as the "State Lottery Fund" is created within the State Treasury which is continuously appropriated for carrying out the purposes of this Chapter. The fund shall receive all proceeds from the sales of lottery tickets or shares, the temporary line of credit for initial start-up costs, and all other moneys credited to the Lottery from any other source. The Treasurer shall designate a depository to receive Lottery proceeds for transmission to the State Treasury and for deposit in the State Lottery Fund.

(b) Except as provided in this Chapter, moneys in the General Fund or any other State fund shall not be transferred to the State Lottery Fund or otherwise used to support the California State Lottery or the Lottery Commission or to pay the debts, obligations, or encumbrances of the State Lottery Fund or the Commission.

Section 8880.62 Types of Disbursements from the State Lottery Fund

Funds shall be disbursed from the State Lottery Fund by the State Controller for any of the following purposes:

(a) the payment of prizes to the holders of valid lottery tickets or shares,

(b) expenses of the lottery,

(c) repayment of any funds advanced from the temporary line of credit to the Commission from the State General Fund for initial start-up costs and the interest on any such funds advanced,

(d) transfer of funds from the State Lottery Fund to the benefit of the public purpose established in this Chapter.

Section 8880.63 Prize Payments

As nearly as practical, 50% of the total projected revenue, computed on a year-round basis for each Lottery Game, accruing from the sales of all lottery tickets or shares from that Lottery Game shall be apportioned for payment of prizes.

Section 8880.64 Expenses

Expenses of the Lottery shall include all costs incurred in the operation and administration of the Lottery and all costs resulting from any contracts entered into for the purchase or lease of goods and services required by the Lottery, including but not limited to, the costs of supplies, materials,

tickets, independent audit services, independent studies, data transmission, advertising, promotion, incentives, public relations, communications, compensation paid to the Lottery Game Retailers, bonding for Lottery Game Retailers, printing, distribution of tickets or shares, reimbursement of costs of services provided to the California State Lottery by other governmental entities, and for the costs for any other goods and services necessary for effectuating the purposes of this Chapter. No more than 16% of the total annual revenues accruing from the sale of all lottery tickets and shares from all Lottery Games shall be expended for the payment of the expenses of the Lottery.

Section 8880.65 Transfer of Net Revenues

The funds remaining in the State Lottery Fund after accrual of all revenues to the State Lottery Fund, and after accrual of all obligations of the Lottery for prizes, expenses, and the repayment of any funds advanced from the temporary line of credit for initial start-up costs and interest thereon shall be deemed to be the net revenues of the Lottery. The net revenues of the Lottery shall be transferred from the State Lottery Fund not less than quarterly to the California State Lottery Education Fund.

Section 8880.66 Intergovernmental Reimbursements for Services

The Commission shall reimburse all other governmental entities for any and all services necessary to effectuate the purpose of this Chapter provided by such governmental entities to the State Lottery Commission.

Section 8880.67 State Controller Audits

The State Controller shall conduct quarterly and annual post-audits of all accounts and transactions of the Commission and other special post-audits as the State Controller deems necessary. The Controller or his agents conducting an audit under this Chapter shall have access and authority to examine any and all records of the Commission, its distributing agencies, Lottery Contractors, and Lottery Game Retailers.

ARTICLE 8

Miscellaneous

Section 8880.68 Taxes

No State or local taxes shall be imposed upon the sale of lottery tickets or shares of the California State Lottery or any prize awarded by the California State Lottery.

Section 8880.69 Preemption of Local Laws

It is the intent of this Chapter that all matters related to the operation of the Lottery as established hereby be governed solely pursuant to this Chapter and be free from regulation and legislation of local governments, including a city, city and county, or county.

Section 8880.70 Lawful Activity

Any other State or local law providing any penalty, disability, restriction, or prohibition for the possession, manufacture, transportation, distribution, advertising, or sale of any lottery tickets or shares shall not apply to the tickets or shares of the California State Lottery.

A business or entity may manufacture, assemble, repair, maintain, print or otherwise produce and transport various devices, paraphernalia, equipment, tickets or other products which are used in a state lottery.

Section 8880.71 Restrictions

No person shall be selected, appointed, or hired to be a Commissioner, Director, deputy director, or Commission employee who has been convicted of a felony or any gambling-related offense.

The following sections 4, 5, and 6 are numbered as they appeared in the Lottery Initiative passed by the voters and in the Chaptered version contained in the California Statutes of 1984. Sections 4 through 6 are not codified in the California Government Code.

SECTION 4

There is hereby established a temporary line of credit to be drawn from the State General Fund to the State Lottery Fund established by this Chapter in the amount of $16,500,000.00 which is continuously appropriated for carrying out the purposes of this Chapter. This line of credit may be drawn upon by the California State Lottery only during the twelve months after the effective date of the Act and only for the purpose of financing the initial start-up of the Lottery. The Lottery may draw upon all or part of this temporary line of credit. Any funds advanced from the temporary line of credit shall be repaid to the State General Fund within twelve months of the advance of said funds. In addition, interest shall be paid at an annual interest rate of 10% on funds advanced from the temporary line of credit commencing on the day funds are advanced.

SECTION 5

No provision of this Act may be changed except to further its purpose by a bill passed by a vote of two-thirds of the membership of both houses of the Legislature and signed by the Governor.

SECTION 6

If any provision of this Act or the application thereof to any person or circumstances is held invalid, such invalidity shall not affect other provisions or applications of the Act which can be given effect without the invalid provision or application, and to this end the provisions of this Act are severable.

Miscellaneous Provisions

Section 470 of Penal Code is amended to read:

470. Every person who, with intent to defraud, signs the name of another person, or a fictitous person, knowing that he or she has no authority so to do, to, or falsely makes, alters, forges, or counterfeits, any charter, letters patent, deed, lease, indenture, writing obligatory, will, testament, codicil, bond, covenant, bank bill or note, post note, check, draft, bill of exchange, contract, promissory note, due bill for the payment of money or property, receipt for money or property, passage ticket, lottery ticket or share purporting to be issued under the California State Lottery Act of 1984, trading stamp, power of attorney, or any certificate of any share, right, or interest in the stock of any corporation or association, or any controller's warrant for the payment of money at the treasury, county order or warrant, or request for the payment of money, or the delivery of goods or chattels of any kind, or for the delivery of any instrument of writing, or acquittance, release, or receipt for money or goods, or any acquittance, release, or discharge of any debt, account, suit, action, demand, or other thing, real or personal, or any transfer or assurance of money, certificate of shares of stocks, goods, chattels, or other property whatever, or any letter of attorney, or other power to receive money, or to receive or transfer certificates of shares to stock or annuities, or to let, lease, dispose of, alien, or convey any goods, chattels, lands, or tenements, or other estate, real or personal, or any acceptance or indorsement of any bill of exchange, promissory note, draft, order, or any assignment of any bond, writing obligatory, promissory note, or other contract for money or other property; or counterfeits or forges the seal or handwriting of another; or utters, publishes, passes, or attempts to pass, as true and genuine, any of the above-named false, altered, forged, or counterfeited matters, as above specified and described, knowing the same to be false, altered, forged, or counterfeited, with intent to prejudice, damage, or defraud any person; or who, with intent to defraud, alters, corrupts, or falsifies any record of any will, codicil, conveyance, or other instrument, the record of which is by law evidence, or any record of any judgment of a court or the return of any officer to any process of any court, is guilty of forgery.

Section 475 of Penal Code is amended to read:

475. Every person who has in his or her possession, or receives from another person, any forged promissory note or bank bill, or bills, or any counterfeited trading stamp, or stamps, or lottery ticket or share purporting to be issued under the California State Lottery Act of 1984, or tickets or shares, for the payment of money or property, with the intention to pass the same, or to permit, cause, or procure the same to be uttered or passed, with the intention to defraud any person, knowing the same to be forged or counterfeited, or has or keeps in his or her possession any blank or unfinished note or bank bill made in the form or similitude of any promissory note or bill for payment of money or property, made to be issued by any incorporated bank or banking company, or any blank or unfinished check, money order, or traveler's check, made in the form or similitude or any check, money order,or traveler's check, whether the parties thereto are real or fictitious, with intention to fill up and complete the blank and unfinished note or bill, check, money order, or traveler's check, or to permit, or cause, or procure

the same to be filled up and completed in order to utter or pass the same, or to permit, or cause, or procure the same to be uttered or passed, to defraud any person, is punishable by imprisonment in the state prison, or by imprisonment in the county jail for not more than one year.

Section 11105.01 of Penal Code is amended to read:

11105.01. In addition to furnishing state summary criminal history information to the persons and entities set forth in Section 11105 and subject to the requirements and conditions set forth in that section, the Attorney General shall furnish state summary criminal history information to the Director, the Deputy Director for Security, and lottery security officers of the California State Lottery.

ETHICAL CONDUCT GUIDELINE
CALIFORNIA STATE LOTTERY

Statement of activities that are inconsistent, incompatible, or in conflict with duties as an officer or employee of the California State Lottery.

Incompatible Activities and Ethical Conduct Policies

The Directive 86-36 issued on April 18, 1986 was adopted and approved by the California State Lottery in compliance with the provisions of Government Code, Section 19990. The following guidelines of the standards of ethical conduct expected are applicable to and shall be followed by every employee and officer, including the Commissioners and the Director, of the California State Lottery (CSL).

Examples of Incompatible Activities

Using the prestige or influence of an office or employment with the California State Lottery for the employee's private gain or advantage, or the private gain* or advantage of another.

Using time, facilities, equipment or supplies of the CSL for the employee's private gain* or advantage, or the private gain* or advantage of another.

Using confidential information acquired by virtue of employment by the CSL for the employee's private gain* or advantage, or the private gain* or advantage of another.

Receiving or accepting money or any other consideration from anyone other than the State for providing any service, performing any work, supporting any advice, offering any help, or taking any action which the employee would be required or expected to render in the regular course of hours of State employment or as a part of the employee's duties with the CSL.

Providing any service, performing any work, supplying any advice, offering any help, or taking any action other than as a State employee knowing that this service, work, advice, help, or action may later be subject, directly or indirectly, to the control, inspection, review, audit or enforcement by the employee or by the CSL.

Receiving or accepting, directly or indirectly, any gift, including monies, any service, gratuity, favor, entertainment, hospitality, loan, or any other thing of value, from anyone doing or seeking to do business of any kind with the CSL, unless authorized by the Director as being of diminutive value (of such small value to deem it of no consequence).

Engaging in any activity or employment, in addition to employment by the CSL, which will so interfere with health or efficiency or have such time demands as to prevent the employee from performing the duties of that person's job with the CSL in an efficient and capable manner.

Having a financial interest** in or being employed by any person or entity which provides goods or services to the CSL, being a CSL Game Retailer, or who has

*Other than salary as CSL employee.

**Financial interests are those that an employee can materially affect through the conduct of her/his office.

provided goods or services to the CSL or been a CSL Game Retailer at any time during the preceding two years, without first obtaining the written consent of the Director, or the Director's designee, who; after examining the facts of the proposed interest or employment, determines that this interest or employment is not inconsistent, incompatible, or in conflict with the employee's duties with the CSL. The spouse or child of the officer or employee living in the same household also shall not have any such interest or employment without the written consent of the Director.

The above standards shall not prohibit the acceptance by an employee of items of nominal value, such as food or beverages, while attending a professional seminar or conference as part of assigned official duties where such items are furnished as part of the seminar or conference to all in attendance and the event is open to the public to attend.

Other Considerations

Although it is not the intent of the CSL to unnecessarily limit nor restrict other employment by employees that does not interfere with or conflict with their official duties and responsibilities, each employee shall advise the Director in writing of all other employment for compensation in which the employee is engaged, including self-employment. Such information concerning this employment as requested by the Director, or the Director's designee, shall promptly be supplied by the employee. The purpose of obtaining this information is so that the Director, or the designee of the Director, may evaluate the employment to determine whether there is or may be a conflict with official duties and responsibilities and the steps that are required to eliminate the conflict.

Each employee shall advise the Director in writing of the employee's membership in or volunteer work for any civic or fraternal organization which is applying for or is a CSL Game Retailer, promptly supplying such information concerning this activity as requested by the Director or the designee of the Director, for the purpose of evaluating the membership or work to determine whether there is or may be a conflict with official duties and responsibilities and the steps that are required to eliminate the conflict.

Employees are advised that the CSL Act of 1984 provides that:

"A (lottery) ticket or share shall not be purchased by, and a prize shall not be paid to a member of the Commission or to any officer or employee of the Commission or to any spouse, child, brother, sister, or parent of such person." (Government Code, Section 8880.32(h).)

This provision of the Act does <u>not</u> apply to "in-law" or "step" relationships (e.g., stepparent, stepchild, mother-in-law, etc.). It <u>does</u> apply to formal adoptive relationships.

This prohibition applies regardless of where the spouse or relative resides.

This statement and the specific activities set forth herein shall not be construed as the sole provisions of law or administrative rules that must be observed by the employees of the CSL. The Director or the Commission may specify additional prohibited activities generally or for designated individuals by an order directed to the individual or persons to whom it applies.

NONDISCRIMINATION CLAUSE

(OCP - 2)

1. During the performance of this contract, the recipient, contractor and its subcontractors shall not deny the contract's benefits to any person on the basis of religion, color, ethnic group identification, sex, age, physical or mental disability, nor shall they discriminate unlawfully against any employee or applicant for employment because of race, religion, color, national origin, ancestry, physical handicap, mental disability, medical condition, marital status, age or sex. Contractor shall insure that the evaluation and treatment of employees and applicants for employment are free of such discrimination.

2. Contractor shall comply with the provisions of the Fair Employment and Housing Act (Government Code, Section 12900 et seq.), the regulations promulgated thereunder (California Administrative Code, Title 2, Section 7285.0 et seq.), the provisions of Article 9.5, Chapter 1, Part 1, Division 3, Title 2 of the Government Code (Government Code, Sections 11135-11139.5) and the regulations or standards adopted by the awarding State agency to implement such article.

3. Recipient, contractor and its subcontractors shall give written notice of their obligations under this clause to labor organizations with which they have a collective bargaining or other agreement.

4. The contractor shall include the nondiscrimination and compliance provisions of this clause in all subcontracts to perform work under the contract.

STATEMENT OF COMPLIANCE

_____ (hereinafter referred to as
(Company Name)

"prospective contractor") hereby certifies, unless specifically exempted, compliance with Government Code Section 12990 and California Administrative Code, Title II, Division 4, Chapter 5 in matters relating to the development, implementation and maintenance of a nondiscrimination program. Prospective contractor agrees not to unlawfully discriminate against any employee or applicants for employment because of race, religion, color, national origin, ancestry, physical handicap, medical condition, marital status, sex or age (over forty).

I _____ hereby swear that I am
(Name of Official)

duly authorized to legally bind the prospective contractor to the above described certification. I am fully aware that this certification executed on _____ in the county
(Date)

of _____ is made under the penalty of perjury
(County)

under the laws of the State of California.

_____
Signature

_____
Title

APPENDIX B

CORRESPONDENCE REGARDING THE BUSINESS INVOLVEMENT OF A LOTTERY CONTRACTOR IN SOUTH AFRICA

This appendix includes correspondence among the several parties involved in the review of a Lottery contractor's statements regarding business involvement in South Africa.

These documents include the following:

1. September 11, 1986 letter from Bally to the California State Lottery.

2. September 17, 1986 letter from Assembly Government Organization Committee to Bally.

3. October 1, 1986 letter from Bally to the Assembly Government Organization Committee.

4. October 10, 1986 letter from Bally to the Assembly Government Organization Committee.

5. October 14, 1986 letter from Scientific Games, Inc. to the California State Lottery.

6. October 29, 1986 letter from the Assembly Committee on Government Organization to the Commission on California State Government Organization and Economy.

7. November 8, 1986 letter from Scientific Games, Inc. to the Chairman, Assembly Committee on Government Organization.

8. November 25, 1986 letter from the Assembly Committee on Government Organization to Scientific Games, Inc.

Bally Manufacturing
Corporation

Law Department

8700 W. Bryn Mawr
Chicago, Illinois 60631
312 399 1300
312 399 1300

DOCUMENT 1

September 11, 1986

Mr. Mark Michalko
California State Lottery
Sacramento, California

Neil E. Jenkins
Secretary and General Counsel
Gary A. Susin
Associate General
Counsel and Assistant Secretary
Michael B. McGarry
Associate General
Counsel and Patent Counsel
Carol R. Stone
Associate General
Counsel
Linda B. Metz
Assistant General
Counsel

Dear Mr. Michalko:

It has come to the attention of the Company that an issue has arisen regarding the conduct of business by the Company in South Africa. It is my information that this issue has been raised in an attempt to protest the recent California Instant Lottery Contract award to the Company's subsidiary, Scientific Games, Inc.

As Secretary and General Counsel of the Company, I represent to you that neither the Company, Scientific Games, Inc., nor any other subsidiary, division or affiliate of the Company has any investments, assets, offices or employees in South Africa. Further, the Company, including its subsidiaries, affiliates and divisions, is not engaged in business in that country.

We further understand that allegations have been made that products of the Company have been observed in operation in South Africa. For your information, the Company has no sales force and directs no sales efforts in that country. Any sales of Company products in South Africa would have been made through independent distributors of the Company's products. As you can appreciate, once products are sold to an independent distributor, the Company has no further control over the ultimate destination of such products.

If you would like to discuss this matter or require further information, please contact the undersigned.

Very truly yours,

BALLY MANUFACTURING CORPORATION

Neil E. Jenkins
Secretary and General Counsel

DOCUMENT 2

MEMBERS
FRANK HILL
VICE CHAIRMAN
TOM BANE
GERALD FELANDO
RICHARD FLOYD
NOLAN FRIZZELLE
ELIHU HARRIS
LUCY KILLEA
ERNEST KONNYU
SUNNY MOJONNIER
GWEN MOORE
STAN STATHAM
LARRY STIRLING
SALLY TANNER
CURTIS TUCKER
FRANK VICENCIA
MAXINE WATERS

California Legislature

Assembly Committee on Governmental Organization

GARY A. CONDIT
CHAIRMAN

STATE CAPITOL
SACRAMENTO 95814
TELEPHONE (916) 445-34
MIKE LYNCH
PRINCIPAL CONSULTANT
MANUEL HERNANDE
PRINCIPAL CONSULTANT
RAY MILLER
SENIOR CONSULTANT
TER HANNA
COMMITTEE SECRETARY

September 17, 1986

Mr. Neil E. Jenkins
Secretary and General
Counsel
Bally Manufacturing
Corporation
8700 W. Bryn Mawr
Chicago, Illinois 60631

Dear ~~Mr.~~ Jenkins: Neil

As you are aware, the California State Legislature is very concerned about the deteriorating situation in South Africa and the violations of human rights conducted by the minority government of that nation.

With the leadership of our Governor, George Deukmejian and Assembly Member Maxine Waters, California has enacted the toughest divestment law in the nation to pressure that government towards necessary change.

In writing and at a recent hearing before the Assembly and Senate Governmental Organization Committees, Scientific Games has assured us that neither it nor its parent company, Bally Manufacturing does any business in South Africa.

Allegations have been made, however, that Bally does, in fact, engage in business activities with South African firms and companies.

I would like you to clarify the record.

I must stress that the Assembly Governmental Organization Committee is interested in the "spirit" not just the letter of the law. For example, if the business activity occurs in any of the so called "homelands" established by the South African

minority government we consider it to have occurred in South Africa. If South Africans came to the United States for training, we consider that doing business with South Africa.

I am sure you will want to answer the following questions as soon as possible. I would appreciate a response by October 1, 1986, so that the Legislature, the Little Hoover Commission, and the California Lottery Commission can have adequate time to review your response.

The questions:

1) Has Bally sold gaming devices directly to purchasers located in South Africa or the South African homelands? If so, when did such sales occur?

2) Has Bally sold gaming devices or other products which it knew or had reason to know were destined for South Africa?

3) Is Bally aware of the locations of its gaming devices in South Africa?

4) Do Bally slot machines, as manufactured at the factory, accept South African coins or do they have to be converted to do so? If conversion does occur, when and where does this happen?

5) Do Bally products shipped to South Africa require certificates of origin? If so, who provides these certificates and to whom are they delivered?

6) Has Bally ever provided or does Bally provide maintenance services for its gaming devices located in South Africa? if so, how and when are such services provided?

7) Has Bally provided or does Bally provide training services for persons or entities which provide maintenance services for Bally gaming devices in South Africa? If so, when and how have such services been provided? If not, how are maintenance services provided?

8) Has Bally provided or does Bally provide security services or training for security services with respect to gaming devices in South Africa? If so, how and where are these services provided?

9) Is David Mercer International, of Reno, Nevada ("DMI"), presently Bally's exclusive worldwide distributor of Bally's products, including gaming devices such as slot machines? If not, who are Bally's other distributors of its products?

10) To Bally's knowledge, has DMI sold, arranged for sale or arranged shipment of Bally gaming devices to customers in South Africa?

11) Has Bally shipped products or arranged for shipment of products sold to or through DMI directly to South African destinations? If not, was Bally aware prior to shipment that any such products were destined for South Africa?

12) Did Bally ever discuss the marketing, sale or distribution of Bally products in South Africa with DMI or any other distributor?

13) Does DMI generally purchase Bally products for its own account and take title to the products prior to resale? Has DMI arranged or coordinated sales of Bally products without taking title to the products?

14) On what basis has Bally delivered or does Bally deliver its products which are sold to DMI? How are shipments to the ultimate purchaser of the products made? To whom are invoices sent upon shipment of such products?

15) Does DMI sell directly to the ultimate purchaser of the products sold by Bally? If not, by what means are Bally products distributed and sold to the end user?

16) Has Bally shipped or does Bally ship or arrange for shipment of products directly to DMI's purchasers?

17) Is DMI a public company? Who are the shareholders or partners owning an interest in DMI of five percent or greater? Where is DMI incorporated or qualified to do business?

18) Has Bally maintained or does Bally maintain any ownership interest in DMI (including any subsidiary or affiliate of DMI)? Has DMI maintained or does DMI maintain any ownership interest in Bally (including any subsidiary or affiliate of Bally)?

19) Do any employees, officers, directors or shareholders of Bally serve as employees, officers or directors of DMI? If

so, what are the names and titles of such persons? Do any shareholders of Bally own shares or partnership interests of DMI? If so, what are the names and interest owned by such persons in each company?

Thank you for your attention to this matter.

Sincerely,

GARY A. CONDIT, Chairman

GAC:mlh

cc Assembly Governmental Organization
Committee Members
Senate Governmental Organization
Committee Members
California Lottery Commission
Little Hoover Commission
Scientific Games
Mr. Nick Konovaloff

DOCUMENT 3

Bally Manufacturing Corporation

Law Department

8700 W. Bryn Mawr
Chicago, Illinois 60631
312 399-1300

October 1, 1986

Neil E. Jenkins
Secretary and General Counsel
Gary A. Gaan
Associate General Counsel and Assistant Secretary
Michael B. McMurry
Associate General Counsel and Patent Counsel
Carol R. Stone
Associate General Counsel
Linda B. Motz
Assistant General Counsel

Mr. Gary A. Condit
Chairman
Assembly Committee on Governmental Organization
California Legislature
State Capitol
Sacramento, California 95814

Dear Mr. Condit:

I have just returned to my office from an extended business trip out of the country and acknowledge receipt of your letter dated September 17, 1986. I will respond to your letter at the earliest possible date.

Very truly yours,

BALLY MANUFACTURING CORPORATION

Neil E. Jenkins
Secretary and General Counsel

NEJ/mts

BY TELECOPY

Bally Manufacturing Corporation

Law Department

8700 W. Bryn Mawr
Chicago, Illinois 60631
312 399-1300

DOCUMENT 4

OCT 14 1986

October 10, 1986

Neil E. Jenkins
Secretary and General Counsel
Cary A. Gaan
Associate General Counsel and Assistant Secretary
Michael B. McMurry
Associate General Counsel and Patent Counsel
Carol R. Stone
Associate General Counsel
Linda B. Motz
Assistant General Counsel

Mr. Gary A. Condit
Chairman
Assembly Committee on Governmental Organization
California Legislature
State Capitol
Sacramento, California 95814

Dear Mr. Condit:

As I advised you in my letter dated October 1, 1986, I was out of the country during the latter part of September and, therefore, unable to respond to your letter dated September 17, 1986. I have now gathered all of the information responsive to the requests contained in your letter and have attached that information, in question and answer form, on Exhibit 1 attached hereto.

However, prior to addressing the specifics of your questions, I should like to comment on the substance of your letter as well as certain information which I believe to be relevant to the issue at hand.

As I previously made clear to the California Lottery Commission in my letter dated September 11, 1986, the Company is not engaged in business in South Africa. The Company's last transaction with a South African firm was the sale of 30 slot machines by a foreign subsidiary which occurred in June, 1984. You have suggested that allegations have been made to the contrary. I would appreciate your advising me at your convenience as to the exact nature of those allegations as well as the source of the allegations. Based upon news articles published in various California papers during the period September 11 through September 13, 1986, copies of which are attached for your reference as Exhibit 2, it appears that such allegations have been made by representatives of Lottery Production Services ("LPS"), a competitor of the Company's subsidiary, Scientific Games. As you may be aware, LPS is an affiliate of Dittler Brothers, Inc., a company which has been engaged in acrimonious litigation with Scientific Games for over a year. As a result of a finding in that litigation that Dittler Brothers engaged in fraud in its dealings with Scientific Games,

Dittler has been prohibited from doing business with the California Lottery. In addition, Scientific Games was awarded compensatory and punitive damages in the amount of $5.6 million as a result of the commission of fraud. LPS was formed by Dittler's parent corporation, Southam, Inc., in an effort to stay in the lottery business after the State of California decided not to do business with Dittler because of the finding of fraud. It is my understanding that LPS' offices are located in Dittler's printing plant in Oakwood, Georgia. LPS could realize a direct economic gain if the California Lottery were to rescind its contract award to Scientific Games. In fact, one of Dittler's lead trial attorneys in the litigation with Scientific Games, Mr. Eugene Partain, has been cited as one of the sources of this "information" with respect to Bally. One could certainly question the motives of LPS and its representatives in making such allegations. I think you will agree that the news articles are misleading at best and that the allegations are completely unfounded.

In your letter you have made reference to the recently enacted California divestment law. You have also suggested that your Committee is interested in the spirit as well as the letter of the law and have provided examples of your interpretation of that new statute. I have now had the opportunity to review the recently adopted legislation introduced by Assembly Member Maxine Waters as Assembly Bill No. 134 and signed into law by Governor Deukmejian as "Chapter 5 (Commencing with Section 16640) to Part 2 of Division 4 of Title 2 of the Government Code, Relating to Investments." In adopting the divestment law, the Legislature has prohibited the investment of state trust moneys in business firms that have business operations in South Africa or business arrangements with the government of South Africa. Business operations are defined in the new law as "the maintenance of equipment, facilities, personnel or any other apparatus of business or commerce, including the ownership or possession of real or personal property located in South Africa". Business arrangements are defined as "projects, vendors, undertakings, contractual relations, or other efforts requiring on-going or periodic performance by either or both parties". Based on the

aforesaid definitions and consistent with my previous representations, Bally has no business operations in South Africa or business arrangements with the government of South Africa. Bally would, therefore, qualify as a suitable investment for the state trust moneys referenced in the new law. Clearly, Bally is in conformance with the "spirit" of the divestment law.

It is obvious that your Committee has been supplied with false information by a disgruntled competitor in an effort to tarnish the good name and reputation of the Company and its subsidiary, Scientific Games, and to jeopardize the business relationship between the State of California and Scientific Games. We respectfully request that the Committee confirm in writing that neither Bally nor Scientific Games has acted in violation of the spirit as well as the letter of the California divestment law as to South Africa and that the public record be made clear that the Committee has been mislead by what could most charitably be described as an over zealous competitor.

We trust that after reviewing the attached information the Committee will be in a position to dispose of this matter expeditiously. If, however, you should require further information or clarification of the enclosed, please do not hesitate to contact the undersigned.

Very truly yours,

BALLY MANUFACTURING CORPORATION

Neil E. Jenkins

Neil E. Jenkins
Secretary and General Counsel

NEJ/mts
Enclosures

BY FEDERAL EXPRESS

cc: Mr. Mark Michalko, California Lottery Commission
(w/ enclosures)

Exhibit 1

1) Has Bally sold gaming devices directly to purchasers located in South Africa or the South African homelands?

Yes.

If so, when did such sale occur?

On September 14, 1982, the Bally Gaming Division sold 18 machines directly to a casino in South Africa. In addition, from 1977 to 1984, the Company sold and shipped machines to its Belgian subsidiary, Bally Continental, which in turn sold such machines to customers in South Africa. During that eight year period, the total number of machines sold was 694. Bally Continental ceased business operations in 1985.

2) Has Bally sold gaming devices or other products which it knew or had reason to know were destined for South Africa?

From 1983 to 1986, the Company sold machines to an independent distributor, David Mercer International, which to the Company's knowledge were destined for South Africa. The total number of such machines was approximately 540.

3) Is Bally aware of the locations of its gaming devices in South Africa?

The Company has reason to believe its machines were sold to various casinos in South Africa.

4) Do Bally slot machines, as manufactured at the factory, accept South African coins or do they have to be converted to do so?

Yes, the slot machines accept various currency including South African coins out of the factory.

If conversion does occur, when and where does this happen?

N/A.

5) Do Bally products shipped to South Africa require certificates of origin?

To the best knowledge of the Company, they do not.

If so, who provides these certificates and to whom are they delivered?

N/A.

6) Has Bally ever provided or does Bally provide maintenance services for its gaming devices located in South Africa?

No.

If so, how and when are such services provided?

N/A.

7) Has Bally provided or does Bally provide training services for persons or entities which provide maintenance services for Bally gaming devices in South Africa?

In 1985, the Company provided one of its independent distributors with an instructor for a training class for slot machine mechanics which was held in West Germany. The Company now has reason to believe that one attendee at the seminar, which was sponsored by the Company's independent distributor, was an employee of a casino in South Africa. The Company was reimbursed for the expenses of providing this service to its distributor by such distributor.

If so, when and how have such services been provided?

See above response.

If not, how are maintenance services provided.

See above response.

8) Has Bally provided or does Bally provide security services or training for security services with respect to gaming devices in South Africa?

No.

If so, how and where are these services provided?

N/A.

9) Is David Mercer International, of Reno, Nevada ("DMI"), presently Bally's exclusive worldwide distributor of Bally's products, including gaming devices such as slot machines?

No.

If not, who are Bally's other distributors of its products?

See attached list of distributors of Bally gaming machines. (Note: Bally's amusement game products are distributed by approximately 50 independent distributors within the United States and 12 independent distributors outside of the United States.)

10) To Bally's knowledge, has DMI sold, arranged for sale or arranged shipment of Bally gaming devices to customers in South Africa?

Yes.

11) Has Bally shipped products or arranged for shipment of products sold to or through DMI directly to South African destinations?

Yes.

If not, was Bally aware prior to shipment that any such products were destined for South Africa.

N/A.

12) Did Bally ever discuss the marketing, sale or distribution of Bally products in South Africa with DMI or any other distributor?

The distribution agreement between Bally and DMI references sales to South Africa among other territories throughout the world.

13) Does DMI generally purchase Bally products for its own account and take title to the products prior to resale?

Yes.

Has DMI arranged or coordinated sales of Bally products without taking title to the products?

Not to the best of the Company's knowledge.

14) On what basis has Bally delivered or does Bally deliver its products which are sold to DMI?

See answer to 13 above.

How are shipments to the ultimate purchaser of the products made?

In the ordinary course of business, shipments are made directly to the ultimate purchaser by Bally FOB the Bally plant in Bensenville, Illinois via common carrier.

To whom are invoices sent upon shipment of such products?

Invoices are sent directly to DMI.

15) Does DMI sell directly to the ultimate purchaser of the products sold by Bally?

Yes.

If not, by what means are Bally products distributed and sold to the end user?

N/A.

16) Has Bally shipped or does Bally ship or arrange for shipment of products directly to DMI's purchasers?

See answer to 14 above.

17) Is DMI a public company?

To the Company's best knowledge, DMI is not a public company.

Who are the shareholders or partners owning an interest in DMI of five percent or greater?

To the Company's best knowledge, the shareholders are David Mercer, Robert Weiss and Roger Rearick.

Where is DMI incorporated or qualified to do business?

To the Company's best knowledge, DMI is incorporated in Nevada.

18) Has Bally maintained or does Bally maintain any ownership interest in DMI (including any subsidiary or affiliate of DMI)?

No.

Has DMI maintained or does DMI maintain any ownership interest in Bally (including any subsidiary or affiliate of Bally)?

None known.

19) Do any employees, officers, directors or shareholders of Bally serve as employees, officers or directors of DMI?

No employees, officers or directors of Bally serve as employees, officers or directors of DMI. Bally is a publicly held corporation with approximately 60,000 shareholders and, therefore, cannot say with certainty whether any officers, directors or employees of DMI are shareholders of Bally. Robert Weiss of Sparks, Nevada is listed in the Company's most recent shareholder list as the holder of 5 shares of common stock. There are approximately 30,000,000 shares outstanding.

If so, what are the names and titles of such persons?

N/A.

Do any shareholders of Bally own shares or partnership interests of DMI?

See above response.

If so, what are the names and interest owned by such persons in each company?

See above response.

INDEPENDENT DISTRIBUTORS OF BALLY GAMING MACHINES

Mr. Sim Teck Teok
A. B. Sim Amusement Services

Mr. Victor Haim
R. H. Belam Company, Inc.

Mr. Ooi Aik Bin
Bally Malaysia Sendirian Berhad

Mr. Eric Rahn
Atlantic Maritime

Mr. Frankie Tan
Alan Frankie Electronics Specialist

Mr. David Mercer
David Mercer International Inc.

Mr. Georges Santa Maria
Bally France

Mr. Yeoh Chew Lim
Union Trading Company

Exhibit 2

CA-D75 SACRAMENTO BEE
(M)231,800 (S)268,962

SEPTEMBER 11, 1986

CLIPPED BY Bacon's

1070

Lottery firm linked to S. Africa

Associated Press

The corporation that owns the company printing California Lottery tickets does business in South Africa, contrary to what it told state officials, a competitor said Wednesday.

Representatives of Lottery Production Services, an unsuccessful bidder on California contracts, said in an interview they have received a report from sources they could not disclose in South Africa detailing the number of Bally Manufacturing Corp. slot machines that have been sold either directly or indirectly for use there.

And Assemblywoman Maxine Waters, a Los Angeles Democrat, said in an interview that she has received unconfirmed information from two sources that Bally deals directly with South African businesses.

Bally, which owns the state's lottery ticket supplier, Scientific Games, told officials recently that neither it nor Scientific Games does any business in that country.

Scientific Games spokesman Leon Tuttle said Wednesday that Bally has no direct sales in South Africa, but sells to independent distributors who may have done business there.

He said Scientific Games has absolutely no connections or involvement with South Africa.

Legislation pending before Gov. Deukmejian orders the divestiture of an estimated $11 billion in state investments from firms doing business with South Africa. The legislation would not affect the lottery in this case since it would ban future and renewed investments, not contracts with firms doing business there.

However, the accuracy of Bally's report to a legislative committee could affect the relations of its subsidiary with California.

The lottery-authorizing ballot initiative of 1984 requires ethical behavior by lottery contractors. The clause was used to drop a subcontractor, Dittler Brothers, which allegedly overcharged for materials.

Lottery Production Services was formed as a sister company to Dittler to bid on California Lottery contracts. LPS currently is protesting against a ticket-printing contract awarded to Scientific Games, which is up for final approval by the Lottery Commission on Friday.

LPS attorney Eugene Partain told lottery commissioners last week that evidence had surfaced that "there had been purchases of Bally slot machines by the Holiday Inns in Transki," South Africa.

"There are apparently 2,300 slot machines in South Africa, and it is believed that 80 percent of them are Bally devices," Partain said.

Assemblywoman Waters said that "information did come to me from two different sources that they do, in fact, have an involvement manufacturing gaming machines for placement in South Africa. Some of these machines are manufactured somewhere in Tahoe.

"It's my understanding that they do sell directly to South Africa. I have information on numbers and where they were sold but . . . I have not had time to deal with it," she said.

CA-D43 LOS ANGELES HERALD-
EXAMINER
(M)285,000 (S)303,000

SEPTEMBER 13, 1986

CLIPPED BY Bacon's

1 070

Firm wins $48 million lottery deal

Panel discounts South Africa ties

SACRAMENTO (AP) — The state Lottery Commission yesterday tacitly dismissed reports that the owner of the firm printing lottery tickets does business in racist South Africa by approving a ticket-printing contract worth as much as $48 million for the company.

With little debate, lottery commissioners awarded the contract to the Georgia-based firm of Scientific Games Inc.

Scientific Games, owned by Bally Manufacturing Corp., engineered the ballot initiative authorizing the lottery in 1984 and landed the initial ticket-printing contract.

Lottery Production Services, one of the unsuccessful bidders on California Lottery contracts, said this week it had received a report, from sources it could not reveal in South Africa, detailing the number of Bally slot machines that have been sold either directly or indirectly for use there.

LPS President William Ardell told commissioners yesterday that a South African attorney, hired by his company, reported that the slot machines had been altered to accept that country's coins by security personnel Bally trained in the United States.

State Assemblywoman Maxine Waters, a Los Angeles Democrat, said this week she would look into unconfirmed information she has received from two sources that Bally deals directly with South African businesses.

But Bally told state officials recently that neither it nor Scientific Games does any business in that country. Bally secretary and general counsel Neil Jenkins reaffirmed that statement in a letter to the lottery Thursday.

But he added that his company sells to independent distributors.

"As you can appreciate, once products are sold to an independent distributor, the company has no further control over the ultimate distribution ...," Jenkins said.

Although commissioners skipped debating the South African matter, Lottery Director Mark Michalko said after the session that he did not have any concerns about the issue in light of Bally's letter.

"Obviously, it would be of concern if we found out they were lying," Michalko said.

:A-D107 VAN NUYS DAILY NEWS
(M)150,000 (S)167,000

SEPTEMBER 11, 1986

CLIPPED BY Bacon's

Bally does work in South Africa, competitor says

Associated Press

SACRAMENTO — The corporation that owns the company printing California Lottery tickets does business in South Africa, contrary to what it told state officials, a competitor said Wednesday.

Representatives of Lottery Production Services, an unsuccessful bidder on California contracts, said in an interview that they have received a report from sources, whom they would not disclose, in South Africa detailing the number of Bally Manufacturing Corp. slot machines that have been sold either directly or indirectly for use there.

Assemblywoman Maxine Waters, a Los Angeles Democrat, said in an interview that she has received unconfirmed information from two sources that Bally deals directly with South African businesses.

Bally, which owns California's lottery ticket supplier, Scientific Games, told state officials recently that neither it nor Scientific Games does any business in South Africa.

Scientific Games spokesman Leon Tuttle said in an interview Wednesday that his company has absolutely no connections or involvement with South Africa. He also said Bally has no direct sales in South Africa, but sells to independent distributors who may have done business there.

"As a result, some (Bally slot machines) may be there (in South Africa). I don't really know," Tuttle said.

South Africa's racist policies have stirred international controversy and, in California, there is legislation pending before Gov. George Deukmejian to get an estimated $11 billion in state investments out of firms doing business with South Africa.

The legislation would not affect the lottery in this case since it would ban future and renewed investments, not contracts with firms doing business in South Africa.

However, the accuracy of Bally's report to a legislation committee on its involvement in South Africa could affect the future relations of its subsidiary with California.

The lottery-authorizing ballot initiative of 1984 requires ethical behavior by lottery contractors. The clause was used to drop a subcontractor, Dittler Brothers, which purportedly overcharged for materials.

Lottery Production Services was formed as a sister company to Dittler to bid on California Lottery contracts, but has been unsuccessful so far. Lottery Production Services is currently protesting against a ticket-printing contract award to Scientific Games, which is up for final approval by the Lottery Commission on Friday.

Lottery Production Services attorney Eugene Partain told lottery commissioners last week that evidence had surfaced that "there had been purchases of Bally slot machines by the Holiday Inns in Transkei," South Africa. "The first lot in 1968 ... A second lot in February of this year, and the third lot is presently on order.

"There are apparently 2,300 slot machines in South Africa, and it is believed that 80 percent of them are Bally devices."

Lottery Production Services President William Ardall said Wednesday that he had received a report from South Africa, the origin of which he would not disclose in order to protect the source, that details the numbers and locations of hundreds of Bally slot machines in the country.

Among the greatest concentrations of machines listed in the report, which The Associated Press obtained, is 100 or more at the Sun City Casino in Bophuthatswana.

Assemblywoman Waters said that "information did come to me from two different sources that (Bally does), in fact, have an involvement manufacturing gaming machines for placement in South Africa. Some of these machines are manufactured somewhere in Tahoe.

"It's my understanding that they do sell directly to South Africa. I have information on numbers and where they were sold but ... I have not had time to deal with it."

//

DOCUMENT 5

SCIENTIFIC GAMES, INC

135 TECHNOLOGY PARKWAY
NORCROSS, GEORGIA 30092-2999, U.S.A.
TELEX: 543646 SCI GAMES
TELEPHONE: (404) 446-0666
CABLE: GAMES

October 14, 1986

Mr. Gary A. Condit
Chairman
Assembly Committee on Governmental Organization
California Legislature
State Capitol
Sacramento, CA 95814

Dear Mr. Condit:

As you are aware, Scientific Games, Inc., a subsidiary of Bally Manufacturing Corporation, was recently awarded a 15 month contract by the California Lottery for instant game tickets. The award to Scientific Games was contested by Lottery Production Services, Inc. (known as "LPS"), the sister corporation of Dittler Brothers, Inc., the former printer of Scientific Games' tickets for California. Dittler/LPS protested the contract award to Scientific Games and falsely alleged in connection with the protest that Bally does business in South Africa. Bally responded to this allegation with its letter of September 11, 1986 from Neil E. Jenkins, Secretary and General Counsel of Bally, to Mark Michalko, Director of the Lottery, stating for the record that Bally is not engaged in business in South Africa:

> "As Secretary and General Counsel of the Company, I represent to you that neither the Company, Scientific Games, Inc., nor any other subsidiary, division or affiliate of the Company has any investments, assets, offices or employees in South Africa. Further, the Company, including its subsidiaries, affiliates and divisions, is not engaged in business in that country."

You then sent your letter of September 17, 1986 to Mr. Jenkins with 19 specific questions to further clarify the issue. Your letter was answered by Mr. Jenkins' letter of October 10, 1986. Again, Bally confirmed that it is not doing business in South Africa. On behalf of Scientific Games, I would like to speak in some detail to the circumstances surrounding the foregoing exchange of letters and the issues raised by them.

We presume that your inquiries relate to recently enacted provisions of California law governing State investments. The relevant California statute (Assembly Bill No. 134) pertains to the divestment by State trust funds of investments in firms that have business operations in South Africa or business arrangements with the government of South Africa. However, it is clear that a ticket procurement by the California Lottery is far removed from investment or divestment decisions relating to California trust funds. Moreover, we are unaware of any comparable inquiry by your Committee on Governmental Organization directed to any other lottery vendor. Several questions then arise. Why were Scientific Games and its parent singled out? Why was the Lottery singled out among State agencies? Why was the most recent procurement singled out? We believe the answer is simply that Dittler/LPS, a disgruntled competitor of Scientific Games with which we are engaged in an acrimonious lawsuit, has provided your office with false information in an effort to gain a short-term competitive advantage over Scientific Games in the recent lottery procurement. We regret that you and your staff have been brought into a controversy between a lottery vendor and its former printer. We regret that the dismantling of apartheid in South Africa, which is a matter of genuine moral concern to Scientific Games and its employees, has become the focus of a lottery procurement in California. We are dismayed that our competitor and its parent would use the moral issue of apartheid in an effort to obtain economic advantage over Scientific Games. I think that you will find, upon full examination of the record, that Bally and Scientific Games have an exemplary policy concerning South Africa, as compared to Southam, Inc. (the Canadian-based parent of Dittler/LPS), and as also compared to other companies with which the State of California does business.

It is meaningful that Dittler and LPS are subsidiaries of a company which does business in South Africa. The parent of Dittler is Southam, Inc., a Canadian corporation, which has extensive publishing interests throughout the world. Southam publications are sold in South Africa in the normal course of Southam's business. It is not surprising to us that this fact was not disclosed to you by Dittler/LPS, its attorneys or lobbyists, because Dittler's lack of corporate integrity was confirmed by a recent finding of fraud against Dittler. As you may be aware, Scientific Games was awarded over $5,600,000 in compensatory and punitive damages for fraud committed against it by Dittler. As a direct result of that finding, Dittler was barred from doing business with the Lottery. Southam, however, in an effort to evade and avoid this debarment, simply incorporated another printing company, LPS, which submitted a competing bid for the most recent lottery procurement. Based on this course of conduct, it is not surprising that Southam does business in South Africa or that Dittler/LPS failed to inform you of that fact. It is also not surprising that they raised an easily refutable false charge against Bally in an effort to gain a short-term competitive advantage in the recent lottery procurement.

In fairness to Dittler, LPS and Southam, it should be stated that many companies which do business with the State of California also do business in South Africa on a regular basis. Some of the more obvious examples are IBM and Ford Motor Company. Others include Moore Corporation Limited, the parent of Response Graphics, a bidder in the recent lottery procurement, and Beatrice, the parent of Webcraft Games, Inc., another bidder in the recent procurement. Moore, for instance, has South African employees, facilities, investments and revenues. Beatrice has similar offices, investments, facilities and revenues. I think you will find of interest a recent article from Barron's, dated April 28, 1986 (copy enclosed), which lists Standard & Poor 500 companies with employees in South Africa. Included in this list are many companies which do business with California. Is your Committee planning to make similar inquiry of Southam, Moore, Beatrice and these other companies as you have done with Bally? In the same article is another list of Standard & Poor 500 companies without employees in South Africa. Please note that Bally is on this list.

We regret that you have been drawn into this extended controversy concerning South Africa by our competitor, Dittler/LPS. Matters of moral importance and genuine national concern should not be used as weapons in a bidding contest brought by a disgruntled losing bidder. We believe that an apology is owed to you by Dittler/LPS, and we also believe that apology could be initiated by a disclosure request from you to Dittler/LPS and Southam similar to the earlier one directed to Bally.

We hope that this letter, together with the earlier letter of Mr. Jenkins, has set the record straight and that the real reason for this matter having come to your attention is now clear.

Very truly yours,

C. Gray Bethea, Jr.
Vice President and
General Counsel

CGB/lw
Enclosure
cc: Assembly Governmental Organization
Committee Members
Senate Governmental Organization
Committee Members
California Lottery Commissioners
M. Mark Michalko, Esq.
Nancy Sweet, Esq.
Dr. John R. Koza
Neil E. Jenkins, Esq.

An Anti-Apartheid Portfolio

It Has Done Better Than the Market

By FLOYD NORRIS

AS THE fuss and furor over "shanties" on college campuses illustrates, the controversy over U.S. investment in South Africa won't go away. The students insist that their schools' endowments sell the shares of companies that do business in South Africa. By so doing, they and other proponents of divestiment contend, a blow will be struck against apartheid.

Those who take the opposite stand also cite ethical grounds to support their position, claiming that divestment would hurt black South Africans. In addition, they point out that the schools and other institutions are fiduciaries. The elimination of shares of companies with a South African connection, they claim, would unfairly diminish the money available for scholarships and a slew of worthwhile academic activities.

The competing ethical considerations apart, most professional observers have taken it as a given that the last argument was right. But they may have to revise their view in light of a study comparing the relative performance of American stocks in companies that do business in South Africa with those that don't.

From the beginning of 1984 through the end of last month, an index of companies without employees in South Africa was up 81%, assuming reinvestment of dividends. An index of companies involved in South Africa was up just 48%, and underperformed in seven of the nine quarters.

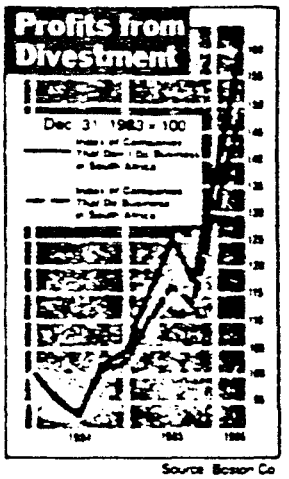
The index was developed by Boston Co., a subsidiary of American Express that manages $125 million under the constraint that no funds be invested in companies involved in South Africa. The Boston SAFE (South Africa Free Equity) Index, which the company plans to update daily, is designed to provide a way for investment managers operating under that stricture to compare their performance to the overall market of stocks eligible for such investment.

Richard Crowell, the manager of Boston's structured investment products division, says signs are that a lot more money is going to be managed under that restriction, since a number of university, church and public funds have promised gradual divestment over the next few years. The sum could grow from around $1 billion at present to $50 billion, he says.

"It's simply another form of social investing, but it is much more encompassing," he explains, noting that some investors have long wanted to keep investments out of certain industries, such as tobacco and liquor or, especially during the Vietnam war, defense.

Most institutions, even public pension funds, are as yet unwilling to simply walk away from investments in companies they don't approve of. They say their fiduciary duty is to make profitable and prudent investments, regardless of where a company does business.

For any institution that does want to divest, the decision is not as easy as it might seem. Figuring out which companies sell booze or bombs is, it turns out, a lot simpler than determining which firms are pure relative to South Africa. Some lists include companies that have signed the Sullivan Principles on doing business in the country, or are paying for audits to assure they are in compliance. Others bar any company that sells to the country, or buys from it.



Source: Boston Co.

Boston Co. uses a relatively simple criterion. Does a company have employees in South Africa? If so, it doesn't qualify. That's a rule with some interesting exclusions. If you buy South African goods, or even allow them to buy your products through independent distributors, you may still qualify. But if you have even one employee in the country, even if you're a model employer, you're on the restricted list.

It applies that criterion to the 500 stocks in the S&P 500, and comes up with 377 that do qualify as South Africa-free. But they tend to be the smaller companies, and together have just 55% of the total market capitalization of the S&P 500. The other 123 stocks make up the rest. Of the 10 stocks with the largest market capitalization, only No. 8 Sears and No. 9 BellSouth are deemed South Africa-free. The others—IBM, Exxon, General Electric, General Motors, AT&T, Royal Dutch, DuPont and Ford—are all restricted.

It is certainly going too far to assert that the mere fact of noninvolvement in South Africa has been the key to better market performance, although the small amount of divestment that has occurred could have made a minor difference in relative performance. As can be seen from the accompanying table, the Boston SAFE Index has a big overrepresentation, relative to the overall S&P 500, of utilities and consumer-service firms. It has a much lower concentration

Comparing Performance

Sector Distribution	S&P 500	Boston SAFE Index
Finance	8%	10%
Health	7	2
Consumer Non-Durables	11	11
Consumer Services	11	19
Consumer Durables	4	3
Energy	11	6
Transportation	3	5
Technology	12	6
Basic Industries	8	9
Capital Goods	10	10
Utilities	13	20
P/E	12.1x	12.3x
Yield	3.6%	3.5%
Dividend Growth (last 5 years)	7.1	8.4
EPS Growth (last 5 years)	9.2	10.3

Source: Boston Co. and Standard & Poor's

S&P 500 Companies With Employees in South Africa

Company	Company	Company	Company	Company
Abbott Laboratories	Champion Spark Plug	Firestone Tire	Kimberly Clark	Schering-Plough
Air Prods. & Chems.	Chase Manhattan	First Interstate	Lubbey-Owens-Ford	Schlumberger
Allie Chalmers	Chesebrough Ponds	Fluor Corp.	Eli Lilly	Seagram
American Brands	Chevron	Ford Motor	MacMillan	SmithKline Beckman
American Cyanamid	Chicago Pneumatic Tool	Foster Wheeler	Marriott	Sperry
American Home Prods.	Citicorp	Fruehauf	Merck	Square D
American Int'l Group	Coca-Cola	GTE	Minnesota Ming. & Mfg.	Squibb
American Standard	Colgate Palmolive	General Electric	Mobil	Standard Oil
AT&T	Control Data	General Motors	Monsanto	Stanley Works
Armstrong Industries	Cooper Industries	General Signal	J.P. Morgan	Sterling Drug
Armco	Crown Corks & Seal	Gillette	NCNB Corp.	Tenneco
Baker International	Cummins Engine	Goodyear Tire	NCR	Texaco
Bank America	Dart & Kraft	W.R. Grace	Newmont Mining	Texas Comm. Bancshares
Baxter Travenol	Deere	Hewlett-Packard	Northern Telecom	Timken
Beatrice	Diamond Shamrock	Honeywell	Owens Illinois	UAL
Black & Decker	Dow Chemical	Hughes Tool	Pan Am	Unilever N.V.
Borden	Dresser Industries	ITT	Parker Hannifin	Union Carbide
Borg Warner	Du Pont	Ingersoll Rand	Pfizer	U.S. Steel
Bristol-Myers	Dun & Bradstreet	Intergraph	Phelps Dodge	United Technologies
Brown-Forman	Eastman Kodak	IBM	Philips Petroleum	Upjohn
Burroughs	Eaton	Int'l Flavors & Fragrances	Reynard Inc.	Warner Communications
CBS	Echlin	Int'l Minerals & Chem.	R.J. Reynolds	Westinghouse
CIGNA	Emery Air Fight	Johnson & Johnson	Rohm & Haas	Xerox
CPC International	Exxon	Jay Mfg.	Royal Dutch	
Caterpillar	FMC Corp.	Kellogg	Sara Lee	

Source: The Boston Co.

of energy and technology issues.

As it happens, any investing strategy that favored utilities and consumer stocks and downgraded energy and technology over the past couple of years would have done relatively well. Crowell also thinks the greater influence of small capitalization stocks has helped, although over this stretch small stocks have generally not been the market stars they were in the late 'Seventies and early 'Eighties.

The Boston SAFE Index, like the S&P 500, is capitalization-weighted, meaning the largest stocks in it have the biggest effect on the index. Of the 11 companies in it with a market capitalization of more than $10 billion, five are regional Bell operating companies, which have been sterling performers, and only one, Amoco, is an oil company. By contrast, the restricted list includes 24 companies with a capitalization of at least $10 billion, five of which are oil companies.

Boston Co. did not put the index together to prove a point about the wisdom of investing in South Africa, only to provide a benchmark to measure the performance of an equity manager barred from buying stocks in companies doing business in that country. As Crowell notes, a manager running a portfolio free of such issues during the last couple of years would have been quite likely to outperform the S&P 500, but economic circumstances, rather than the manager, deserve most of the credit.

Still the Boston Co. study is sure to strengthen the hand of the divestment camp. ■

S&P 500 Companies Without Employees in South Africa

Company	Company	Company	Company	Company
AMP	Chemical New York	Georgia Pacific	McGraw Hill	St Paul Cos
AMR Corp	Chrysler	Gerber Products	Mead	Sanders Associates
ASA Ltd	Chubb	B F Goodrich	Melon Bancorp	Santa Fe Southern Pac
Acme Cleveland	Church's Fried Chicken	Gould	Mellon	Scientific Atlanta
Advanced Micro Devices	Cincinnati Milacron	W W Grainger	Mercantile Stores	Scott Paper
Aetna	Clark Equipment	Great A&P Tea	Meredith	Seaboard Power
H F Ahmanson	Clorox	Great Atl Pac Tea	Merrill Lynch	Sears Roebuck
Albertic Culver	Coastal Corp	Great Western Fin L	Middle South Utils	Shared Med Sys
Albertsons	Coleco	Grumman	Mohasco	Sherwin Williams
Alcan Alum	Colgate	Gulf & Western	Monarch Machine Tool	Shoneys
Allied Signal	Collins & Aikman	Halliburton	Monsanto	Singer Co
Allied Stores	Colt Inds	Handleman Co	MOTOROLA	Skyline
Aluminum Co Amer	Columbia Gas Sys	Harcourt Brace Jovanovich	NL Industries	Snap On Tools
Amax	Combustion Engr	Harris Corp	NWA Inc	Sonat
Amerada Hess	Commonwealth Ed	Hartmarx	National Distillers & Chem	So Calif Edison
American Can	Computer Sciences	Hasbro	National Gypsum	Southern Co
American Elec Pwr	Computervision	G Heileman	National Intergroup	Southland
American Express	ConAgra	H J Heinz	National Med Enterprises	Southwestern Bell
American Gen Corp	Consol Edison	Hercules	National Semiconductor	Springs Industries
American Info Tech	Consolidated Freightways	Hershey Foods	New York Times	J P Stevens
American Med Int'l	Consolidated Nat Gas	Hilton Hotels	Niagara Mohawk Pwr	Stone Container
American Motors	Continental Corp	Holiday Corp	Norfolk Southern	Sun Co
American Stores (new)	Coors	Homestake Mng	North Amer Coal	Super Valu Stores
Amoco	Corning Glass	Hospital Corp Amer	Northern St Pwr	SYNTEX
Andrew	Crane	Household Int'l	Northrop	TRW
Anheuser Busch	Cray Research	Houston Industries	Norwest	Taft Broadcasting
Apple Computer	Cross & Trecker	Humana	Nexell	Tandem Computers
Archer-Daniels-Midland	Crown Zellerbach	IC Industries	Nucor	Tandy
Armstrong World Inds	Cullinet Software	Idea Basic Inds	NYNEX	Tektronix
Asarco	DSC Communications	Illinois Tool Wks	Occidental Pete	Telecommunications
Assoc Dry Goods	Dana	Inco	Ohio Edison	Teledyne
Atlantic Richfield	Data General	Inland Steel	Oneida	Texas Eastern
Automatic Data Proc	Datapoint	Inland Stores	Oshkosh B'gosh	Texas Instrs
Avon Products	Dayton-Hudson	Intel	Outboard Marine	Texas Utilities
Ball Corp	Delta Air Lines	Interco	Overnight Transp	Textron
Bally Manufacturing	Detroit Edison	Interfirst	Owens-Corning Fiberglas	Thomas & Betts
Baltimore Gas & Elec	Digital Equipment	Interlake	PPG Industries	Tiger Int'l
Bank of Boston	Disney	Int'l Harvester	Paccar	Time Inc
Bankers Trust	Dome Mines	International Paper	Pacific G&E	Times Mirror
C R Bard	Dominion Res	Interstate	Pacific Lighting	Tonka
Barnett Banks	R R Donnelley & Sons	Jefferson Pilot	Pacific Telesis	Toys R Us
Bassett Furniture	Dover		Panhandle Eastn	Tracor
Becor Western	Dow Jones	K mart	J C Penney	Transamerica
Becton Dickinson	Dow Power	Kaiser Alum	Pennzoil	Travelers
Bell Atlantic	EG&G	Kaiser Cement	Peoples Energy	Tribune Co
BellSouth	E Systems	Kaufman & Broad	PepsiCo	USF&G
Bemis	Eastern Gas & Fuel	Kerr-McGee	Perkin-Elmer	USG Corp
Beneficial Corp	Jack Eckerd	Knight Ridder News	Philip Morris	Union Camp
Bethlehem Stl	Emerson Elec	Kroger	Pitney Bowes	Union Pac
Boeing	Engelhard	LTV	Pittston	United Cable TV
Borg Cascade	Enserch	Leaseway Transp	Polaroid	U S Home
Briggs & Stratton	Ex-Cell-O	Limited Co	Potlatch Corp	U S West
Brown & Sharpe Mfg	FPL Group	Lin Broadcasting	Price Co	Unocal
Brown Group	Fedders USA	Lincoln Nat'l	Prime Computer	USLife
Browning-Ferris	Federal Express	Litton Industries	Procter & Gamble	UV Corp
Brunswick	Federal Paper	Liz Claiborne	Public Svc Indiana	Wal Mart Stores
Burlington Inds	Federated Dept Stores	Lockheed	Public Svc Elec & Gas	Walgreen
CNA Fin'l Corp	Financial Corp Amer	Lone Star Inds	Pulte Home	Hiram Walker
CNW Corp	First Chicago	Long's Drug Stores	Quaker Oats	Jim Walter
CSX	First Mississippi	Loral	RCA	Wang Labs
Burlington North	First Pennsylvania	Louisiana Ld & Expl	Ralston Purina	Warner-Lambert
Campbell Red Lake Mines	Fleetwood Enterprises	Louisiana Pac	Ramada Inns	Waste Mgt
Campbell Soup	Fort Howard Paper	Lowe's Co	Raytheon	Wendy's Int'l
Capital Cities Commun	Gannett	Luby's Cafeterias	Reading & Bates	West Point Pepperell
Capital Holding	General Cinema	Lucky Stores	Redman Industries	Western Co N Am
Carter Hawley Hale Stores	General Dynamics	M/A-Com	Revco DS	Westmoreland Coal
Celanese	General Instrument	MCA	Reynolds Metals	Weyerhaeuser
Centex	General Mills	MCI Communications	Rite Aid	Whirlpool
Central & South West	Genesco	MEI Corp	Roadway Services	White Consolidated
Champion Int'l	Genuine Parts	MGM UA Entmt	Rockwell Int'l	Williams Cos
		R H Macy	Rollins Environmental Svcs	Winn Dixie Stores
		Mfrs Hanover	Roper	Woolworth
		Martin Marietta	Rowan Cos	Wm Wrigley Jr
		Masco	Russell Corp	Yellow Frt Sys
		Massey Ferguson	Ryan Homes	Zayre
		Mattel	Ryder Sys	Zenith
		May Dept Stores	Safeco Corp	Zurn Industries
		Maytag	Safeway Stores	Source: [illegible]
		McDermott Int'l		
		McDonald's		
		McDonnell Douglas		

Research Reports

Continued from Page 39

looks attractive to raiders? "We're selling for three times book value," he notes. "If someone wants to buy us at six or seven times book, we might have to consider it."

In the meantime, Seibald estimates Zayre's '86 net will be $4.30 a share, with $5.25 possible next year. That compares with $3.23 in '85.

Other research reports recently issued by investment houses include the following:

- **Borg Cascade (BCC-NYSE)**
  by Drexel Burnham Lambert

  Neutral. '86 should be a transition period, leading to better pricing and profits in '87 and '88.

- **Chase Manhattan (CMB-NYSE)**
  by Salomon Brothers

  The cheapest of the cheap bank stocks. Balance sheet improving, loan loss reserve ratio has grown in the past seven quarters.

- **Central Data (CDA-NYSE)**
  by Piper, Jaffray & Hopwood

  Reasonably priced, two or three quarters away from profitability on an operating basis.

- **Digital Communications Associates (DCAI-OTC)**
  by Robertson Colman & Stephens

  Attractive long-term one of a handful of data-communications companies that has achieved consistent revenues and earnings growth.

- **Duquesne Co. (DCI-NYSE)**
  by Dain Bosworth

  Recommended cutting costs and maximizing margins in three areas related to core business: air cleaners and snuffers for heavy-duty mobile equipment.

- **Dun & Bradstreet (DNB-NYSE)**
  by Drexel Burnham Lambert

  Enthusiastically recommended; earnings are highly predictable, balance sheet is "fortress like."

- **Endotronics (ENDO-OTC)**
  by Piper, Jaffray & Hopwood

  Accumulate on [illegible] Biotechnic development [illegible] machine for hospitals [illegible] or manufacturing [illegible] certain types of cancer.

- **Georgia-Pacific (GP-NYSE)**
  by Argus

  But, the likelihood [illegible] paper [illegible] $1 a share in earnings over the next [illegible] years.

- **Great Western Systems (GWSI-OTC)**
  by Rooney Pace

Continued on Next Page

DOCUMENT 6

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California Legislature

Assembly Committee on Governmental Organization

GARY A. CONDIT
CHAIRMAN

STATE CAPITOL
SACRAMENTO 95814
TELEPHONE (916) 445-3451

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TERI HANNA
COMMITTEE SECRETARY

October 29, 1986
Sacramento, California

Mr. Nathan Shapell, Chairman
Commission on California State
Government Organization and Economy
1127 - 11th Street, Suite 550
Sacramento, CA 95814

Dear Mr. Shapell:

I regret that I will not be able to attend your Commission's hearing on October 29, 1986.

I am writing this letter because of my concern that legislative committees may have been misled earlier this year about the involvement of a Lottery contractor, or its parent company, in conducting business in South Africa.

On June 24, 1986, the Assembly and Senate Governmental Organization Committees, while meeting in a joint session, were told that neither Scientific Games nor its parent corporation, Bally Manufacturing Corporation, does <u>any</u> <u>business</u> in South Africa. (See attached pages 84-85 of the Legislative hearing: Attachment A). Also, Scientific sent a letter confirming this representation to the Director of the Lottery Commission on the same day (See letter from Robert Mote, Executive Vice President and Chief Legal Officer, Scientific Games, June 24, 1986: Attachment B).

After receiving information that Bally Manufacturing Corporation may be conducting business in South Africa, I sent a letter dated September 17, 1986, to that company asking if it is doing business in South Africa.

In response to my letter, I was advised in an October 10, 1986 letter by Mr. Neil Jenkins, Secretary and General Counsel, Bally Manufacturing Corporation, that Bally "is not engaged in business in South Africa."

A close examination of Bally's detailed responses, which accompanied their letter, contradict the assertions made in the main body of the letter. The

Bally Corporation admits that it has been selling gaming machines to David Mercer International, a distributor with which Bally has a distribution agreement, which the Bally Corporation knew were destined for South Africa. David Mercer International is the apparent exclusive supplier of Bally machines for South Africa. In fact, Bally admits the machines are shipped directly by Bally FOB the Bally plant in Illinois via a common carrier to the ultimate purchaser in South Africa.

This is doing business in South Africa to my understanding.

The responses from Scientific Games and the Bally Manufacturing Corporation appear to make an attempt to limit the scope of my inquiry to the recently enacted Divestment Act. This is not and never has been the intent of the committee's questions. The committee's inquiry was whether Bally or Scientific Games are doing business in South Africa.

The issue to me is whether the Legislature and the Lottery Commission were misled. If so, should the Lottery Commission suspend a contract for misleading statements which constitute dishonest conduct under the provisions of the Lottery Act and whether this conduct compromises the integrity of the State Lottery.

In the near future, my committee will hold follow-up hearings on many of the matters which are the subject of today's hearing, including bid procurement and evaluation policies of the State Lottery.

I want to compliment your Commission for this hearing on the State Lottery. The testimony and data will no doubt play an important part in the upcoming legislative hearings.

Sincerely,

GARY A. CONDIT

GAC:mhs

Enclosures

cc Little Hoover Commission Members
Assembly Governmental Organization
Committee Members
Senate Governmental Organization
Committee Members
California Lottery Commission
M. Mark Michalko
Bally Manufacturing Corporation
Scientific Games
Mr. Nick Konovaloff

Attachment A

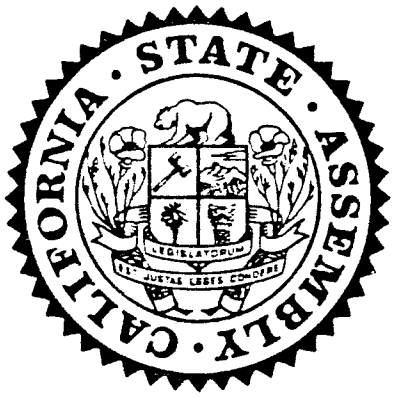
ASSEMBLY AND SENATE COMMITTEES
ON
GOVERNMENTAL ORGANIZATION

TRANSCRIPT OF PROCEEDINGS

Joint Hearing on

THE CALIFORNIA STATE LOTTERY

STATE CAPITOL
JUNE 24, 1986



ASSEMBLY COMMITTEE MEMBERS PRESENT:
Gary A. Condit, Chairman
Frank Hill, Vice Chairman
Rusty Areias
Elihu Harris
Lucy Killea
Sunny Mojonnier
Maxine Waters

SENATE COMMITTEE MEMBERS PRESENT:
Ralph C. Dills, Chairman
Alfred Alquist
Robert Beverly
John Foran
Bill Greene

ASSEMBLY STAFF PRESENT:
Mike Lynch, Principal Consultant
Manuel Hernandez, Principal Consultant
Teri Hanna, Committee Secretary

SENATE STAFF PRESENT:
Lindsay W. Miller, Principal Consultant
Steve Hardy, Senior Consultant
Art Terzakis, Associate Consultant

No. 080J

UNIDENTIFIED VOICE: (Inaudible).

SENATOR GREENE: What is it?

MS. FONTENETTE: Barton, Burton ... -- in the industry they go by ...

SENATOR GREENE: Will you please come forward to tell us?

CHAIRMAN CONDIT: While this gentleman is coming up, I want to remind the committee that there are 5 or 6 people who've been sitting in the audience during this portion of the agenda who would like to come up and make some statements, so I would ...

SENATOR GREENE: He's going to write that name down.

CHAIRMAN CONDIT: Are you finished, Senator?

SENATOR GREENE: Yes.

CHAIRMAN CONDIT: What I would like to do, if I may, is bring them up.

ASSEMBLYWOMAN WATERS: Are any of these minority participants in this (inaudible).

MR. GUTIERREZ: I would have to direct that ...

CHAIRMAN CONDIT: Do you have an answer?

SENATOR GREENE: Where's their headquarters?

CHAIRMAN CONDIT: We have two questions that have not been answered for Ms. Waters -- the South African question and this ...

MR. GUTIERREZ: Mr. Condit, I just received the answer with respect to the South Africa question, and also, Senator Dills, I would like to correct the statement that you made with

respect to the Georgia litigation. I have just been handed a letter from Scientific Games, in response to my June 12th letter, and I would like to read that for the record to correct any.

CHAIRMAN CONDIT: Why don't you just tell us what the letter says and then submit it?

MR. GUTIERREZ: Okay. With respect to the South Africa question, neither Scientific Games nor its parent corporation, Bally Manufacturing Corporation does any business, whatsoever, in South Africa.

Secondly, in terms of the Georgia litigation, today, the Scientific Games people advise that they've just been advised, telephonically, that the auditor has denied the emergency motion of Scientific Games. The auditor did not discuss, nor disturb, the prior findings of Gott versus Dittler, and did not issue any new injunctions, so that is to correct the earlier statement that was made that the auditor, somehow, changed the findings of fraud. He did not even address those.

CHAIRMAN CONDIT: Well, it's the finding of fraud that are stayed at this point by the Court, is that correct? That doesn't change anything at all. I didn't hear that indication from him. Well, let's not get back into that. We have an enormous -- I mean you're going to come back at some time and we're going to talk about that some more.

I want to ask -- I know there are people in the audience that have been waiting a long time to come up. I would like to hear from several of you that have seen what's going on; try not to duplicate what you've heard said up here. If you've got a

Attachment B

June 24, 1986

M. Mark Michalko
California State Lottery
600 North 10th Street
Sacramento, CA 95814

Dear Mr. Michalko:

We have just been advised telephonically that the auditor has denied our emergency motion. The auditor did not discuss or disturb the prior findings of fraud against Dittler and did not issue any new injunctions. Rather, the auditor simply denied in pertinent part the cross motions filed by both parties. As a result, we are unable to provide the assurances required by your letter of June 12, 1986. In the event of a decision by the Lottery to rebid the contract, the auditor has suggested that appropriate relief should be sought from Judge Williams (rather than the auditor) to extend Judge Williams' June 4 order allowing Scientific to bid alone in Pennsylvania to any California rebid.

When we obtain a copy of the auditor's ruling in this regard or any further information, we will supply it to you.

Very truly yours,

Robert L. Mote
Executive Vice President and
Chief Legal Officer
Scientific Games, Inc.
RLM/rm

p.s. In response to an inquiry raised at the hearing, please be advised that neither Scientific Games nor its parent corporation, Bally Manufacturing Corporation, does any business in South Africa.

DOCUMENT 7

SCIENTIFIC GAMES, INC.

135 TECHNOLOGY PARKWAY
NORCROSS, GEORGIA 30092-2999, U.S.A.
TELEX: 543646 SCI GAMES
TELEPHONE: (404) 446-0666
CABLE: GAMES

November 8, 1986

NOV 21 1986

Assemblyman Gary A. Condit
Chairman
Assembly Committee on Govermental Organization
California Legislature
State Capitol
Sacramento, CA 95814

Dear Assemblyman Condit:

In Neil Jenkins' October 20 letter to you, Mr. Jenkins referred to your September 17 statement that allegations have been made about Bally doing business in South Africa. Mr. Jenkins asked: "I would appreciate your advising me at your convenience as to the exact nature of those allegations as well as the source of the allegations."

In Gray Bethea's October 14 letter to you, Mr. Bethea advised that Southam, Moore and Beatrice all do direct business with South Africa, unlike Bally. He asked if you are "planning to make similar inquiry of Southam, Moore, and Beatrice, and these other companies as you have done with Bally" and requested you to send "a disclosure request to Dittler/LPS and Southam similar to the earlier one directed to Bally."

To date, we have received no response to either letter. We would appreciate your responding by Friday, November 14, 1986. Thank you.

Yours truly,

Robert L. Mote
Executive Vice President and
Chief Legal Officer

RLM/vh

DOCUMENT 8

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GWEN MOORE
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LARRY STIRLING
SALLY TANNER
CURTIS TUCKER
FRANK VICENCIA
MAXINE WATERS

California Legislature

Assembly Committee on Governmental Organization

GARY A. CONDIT
CHAIRMAN

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MANUEL HERNANDEZ
PRINCIPAL CONSULTANT
RAY MILLER
SENIOR CONSULTANT
TERI HANNA
COMMITTEE SECRETARY

November 25, 1986
Sacramento, California

Robert L. Mote
Executive Vice President and
Chief Legal Officer
Scientific Games, Inc.
135 Technology Parkway
Norcross, Georgia 30092-2999

Dear Mr. Mote:

In reference to your recent letter, the issue before the Governmental Organization Committee regarding South Africa and Scientific Games rests solely on the statements made by Scientific Games to the Legislature's Committees on Governmental Organization stating that neither Scientific Games, nor its parent corporation Bally Manufacturing, does <u>any</u> business in South Africa.

It is clear from the background information provided by the Bally Manufacturing Corporation that Bally has extensive dealings in South Africa. The only remaining questions are whether Scientific Games' and Bally's statements to California governmental entities were deliberate misrepresentations constituting sufficient reasons to invoke Sections 8880.24 and 8880.35 of the Government Code (the California State Lottery Act) and, if so, should California revoke Scientific Games' contract with the Lottery Commission.

Sincerely,

GARY A. CONDIT

GAC:mls
cc: Little Hoover Commission