



**OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA**

FINANCIAL AUDIT DIVISION REPORT

Minnesota State Lottery

**Internal Controls, Compliance, and
Information Technology Audit**

January 2014 through February 2016

November 4, 2016

Report 16-16

FINANCIAL AUDIT DIVISION
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Conclusion on Internal Controls

The Financial Audit Division bases its conclusion about an organization's internal controls on the number and nature of the control weaknesses we found in the audit. The three possible conclusions are as follows:

Conclusion	Characteristics
Adequate	The organization designed and implemented internal controls that effectively managed the risks related to its financial operations.
Generally Adequate	With some exceptions, the organization designed and implemented internal controls that effectively managed the risks related to its financial operations.
Not Adequate	The organization had significant weaknesses in the design and/or implementation of its internal controls and, as a result, the organization was unable to effectively manage the risks related to its financial operations.



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA • James Nobles, Legislative Auditor

November 4, 2016

Representative Sondra Erickson, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Michael Vekich, Acting Executive Director
Minnesota State Lottery

This report presents the results of our internal controls and compliance audit of the Minnesota State Lottery for the period from January 1, 2014, through February 29, 2016. The objectives of this audit were to determine if the office had adequate information technology and financial internal controls and complied with selected legal requirements.

We discussed the results of the audit with the Minnesota State Lottery's staff at an exit conference on Monday, October 24, 2016. This audit was conducted by Michael Anderson, CPA, CISA (IT Audit Director), Michael Fenton, CISA, (IT Audit Coordinator), Laura Wilson, CPA, CISA (Financial Audit Coordinator), and assisted by auditor(s) Thom Derus, CISA, Kevin Herrick, Jackie Merriam, CPA, Ali Shire, and Melissa Strunc, CPA.

We received the full cooperation of the Minnesota State Lottery's staff while performing this audit.

A handwritten signature in black ink that reads "James R. Nobles".

James R. Nobles
Legislative Auditor

A handwritten signature in black ink that reads "Cecile M. Ferkul".

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

Minnesota voters approved a constitutional amendment in 1988 that allowed the state to create and operate a lottery.¹ The Lottery offers two types of games: lotto games (such as Powerball, Mega Millions, Gopher 5, Daily 3) and scratch games with a variety of ticket types, prices, and themes. In fiscal year 2016, the Lottery's sales were about \$593 million, and it contributed nearly \$96 million of its net proceeds to the state's Environment and Natural Resources Trust Fund and its General Fund.

In conducting the audit, we had the following objectives:

- Determine whether the Lottery had adequate internal controls over its information technology.
- Determine whether the Lottery had adequate internal controls over its financial activities.
- Determine whether the Lottery complied with the legal requirements we selected for testing.
- Determine whether the Lottery resolved prior audit findings.²

Conclusions

The Minnesota State Lottery had generally adequate internal controls over its information technology, but it had some weaknesses as noted in Findings 1 through 7.

The Minnesota State Lottery had generally adequate internal controls over its financial activities, but it had some weaknesses as noted in Findings 7 through 9.

The Minnesota State Lottery generally complied with the legal requirements we tested, except as stated in Finding 8. In addition, we provide an analysis in Appendix A of two prior Lottery practices we think are legally questionable. The Lottery ended both practices July 1, 2016.³

¹ Minnesota Constitution, art. XIII, sec. 5. The Lottery was created by the Legislature in 1989 (see *Laws of Minnesota* 1989, chapter 334, art. 3) and operates under laws codified in *Minnesota Statutes* 2015, 349A.

² Office of Legislative Auditor's Financial Audit Division Report 13-12, *Minnesota State Lottery*, issued June 20, 2013.

³ Benjamin Freedland, General Counsel, Minnesota State Lottery, memorandum to Executive Team, *Lottery Prize Policy Changes*, June 21, 2016.

The Minnesota State Lottery resolved all five of the prior findings as shown in Appendix B.

Key Findings

- The Minnesota State Lottery did not have sufficient formal, documented policies and procedures for all information technology control areas. (Finding 1, page 13)
 - The Minnesota State Lottery did not always have sufficient evidence of the review and approval of changes made to its computer systems. (Finding 2, page 14)
 - The Minnesota State Lottery did not have an adequate plan to recover its information technology operations in the event of a disaster. (Finding 3, page 15)
 - The Minnesota State Lottery did not periodically ensure it appropriately limited people's access to its information systems and physical facilities. (Finding 4, page 16)
 - The Minnesota State Lottery did not adequately limit employee access to retailers' not public information. (Finding 7, page 18)
-

Minnesota State Lottery

Agency Overview

In 1988, Minnesota voters approved an amendment to the state's constitution that authorized the Legislature to create a state lottery.⁴ The following year, the Legislature established the Minnesota State Lottery,⁵ and it began operations in 1990.

In 1990, Minnesota voters approved an amendment to the state's constitution that dedicated "not less than 40 percent of the net proceeds from any state-operated lottery" to the Minnesota Environment and Natural Resources Trust Fund until 2001.⁶ In 1998, a constitutional amendment extended that requirement until 2025.⁷

The Lottery offers two types of games: lotto games (such as Powerball, Mega Millions, Gopher 5, Daily 3) and scratch games with a variety of ticket types, prices, and themes. State law requires the Lottery to pay 45 percent of gross receipts in prizes each fiscal year for the lotto games and 60 percent for the scratch games.⁸

The Lottery has its headquarters in Roseville, Minnesota, and four regional offices located in Virginia, Detroit Lakes, Marshall, and Owatonna. It contracts with local retailers, such as gas stations, convenience stores, and grocery stores, to sell Lottery tickets to the public.

In February 2016, Governor Mark Dayton appointed Michael Vekich as the Lottery's interim executive director. The previous executive director, Edwin Van Petten, served from February 2012 through December 2015. Kristin Batson served as the interim executive director from December 2015 through January 2016.

⁴ *Minnesota Constitution*, art. XIII, sec. 5; proposed in *Laws of Minnesota* 1988, chapter 690, art. 1, sec. 2.

⁵ *Laws of Minnesota* 1989, chapter 334, art. 3.

⁶ *Minnesota Constitution*, art. XI, sec. 14; proposed in *Laws of Minnesota* 1990, chapter 610, art. 1, sec. 55.

⁷ *Minnesota Constitution*, art. XI, sec. 14; proposed in *Laws of Minnesota* 1998, chapter 342.

⁸ Minnesota Statutes 2015, 349A.10, subd. 2(b). Gross receipts generally include the revenues from the sale of lotto and scratch tickets less the Lottery's payments to the Department of Revenue in lieu of sales taxes. In lieu of charging Lottery ticket purchasers sales tax, the Lottery pays the Department of Revenue 6.5 percent of lotto and scratch game ticket sales, as required by *Minnesota Statutes* 2015, 297A.65.

Mr. Van Petten resigned in December 2015 amid questions raised about \$7,390 in reimbursements he received after staying with other Lottery staff at his personal timeshare units. These lodging arrangements occurred while attending four different business-related conferences between September 2013 and June 2015. The Department of Management and Budget reviewed the propriety of the reimbursements and concluded the reimbursements did not comply with the state's travel policy.⁹ Mr. Van Petten subsequently repaid the Lottery in May 2016.

Legal Changes to Lottery Operations

In 2015 the Minnesota Legislature passed a law that added restrictions to the Lottery's gaming operations.¹⁰ According to the new law:

- The Lottery may not offer electronic casino-style games, including blackjack, craps, keno, dice games, roulette, and poker.
- The Lottery may not sell tickets at a self-service device adjacent to gas pumps, such as a "Play at the Pump."
- The Lottery may not sell tickets at a self-service device adjacent to electronic financial terminals, such as automatic teller machines.
- The Lottery may not sell instant win lottery tickets through a website.

Once this law became effective on September 26, 2015, the Lottery amended portions of its contract with Scientific Games International, Inc., the company that helped the Lottery implement and operate the types of games the new law prohibited. In November 2015, the Lottery negotiated a Settlement and Release Agreement with Scientific Games International, Inc. and paid the company \$3.5 million in exchange for a release of all past and present lawsuits related to the law.

Information Technology Operations

The Lottery manages its own computer operations, using a primary and backup data center.¹¹ It contracts with International Game Technology PLC (IGT)¹² to support the operations and data collection for the lotto games. IGT owns and

⁹ Department of Management and Budget policy PAY0021, *Employee Business/Travel Expenses, Policy – Meals and Lodging*. This policy prohibits state agencies from reimbursing employees for staying at the employee's personally-owned property.

¹⁰ Minnesota Laws 2015, chapter 45, sec. 25 updated Minnesota Statutes 2015, 349A.13.

¹¹ Minnesota Statutes 2015, 16E.016 (d) exempts the Lottery from the oversight of the Office of MN.IT Services, the state's consolidated information technology service provider.

¹² International Game Technology PLC (IGT) is a multinational gaming company that produces slot machines and other gaming technology.

manages the equipment used by local retailers to generate Lottery tickets for the public and calculates the prize payouts for the winning tickets. IGT submits detailed information about the tickets sold and prize payouts for the lotto games to the Lottery.

The Lottery's primary computing system runs two gaming applications, one for the lotto games and the other for the scratch games. Also, because the state's accounting system is not the Lottery's primary accounting system, it uses a purchased accounting software system for its nonpayroll financial operations.¹³

Financial Operations

The Lottery does not receive a state General Fund appropriation; instead, it operates using a portion of the gaming revenues collected. State statutes establish the State Lottery Fund and key legal provisions governing its finances, including: prize payout percentages, operations and advertising spending limits, budget requirements, and transfers of the net lottery proceeds to other state funds.¹⁴ In addition, state law limited the Lottery's annual operating budget to \$30.5 million for fiscal years 2014 and 2015 and \$31 million for fiscal year 2016.¹⁵

The Lottery submits 6.5 percent payment of its ticket sales to the Department of Revenue in lieu of sales tax on lottery tickets.¹⁶ Table 1 shows how state statutes require the Department of Revenue to deposit these taxes into the various governmental funds.¹⁷

Table 1
Statutory Required Distribution of
Lottery in Lieu of Sales Tax

<u>Fund</u>	<u>Percentage</u>
General	27.57
Game and Fish	36.21
Natural Resources for:	
State Parks and Trails	16.30
Metropolitan Parks and Trails	16.30
Local Trail Grants	2.17
Three Zoos	1.45
Total	<u>100.00</u>

Source: *Minnesota Statutes 2015, 297A.94 (e).*

¹³ The Lottery uses the state's human resources and payroll system and records the summary payroll expenses in the purchased accounting software.

¹⁴ *Minnesota Statutes 2015, 349A.10.*

¹⁵ *Laws of Minnesota 2013, Chapter 142, art. 1, sec. 17* and *Laws of Minnesota 2015, Chapter 77, art. 1, sec. 17.*

¹⁶ *Minnesota Statutes 2015, 297A.65 and 297A.62.*

¹⁷ *Minnesota Statutes 2015, 297A.94 (e).*

After paying the Department of Revenue the in lieu of sales taxes and paying out prizes and operating costs, the Lottery pays the balance to the state's General Fund (60 percent) and the Environment and Natural Resources Trust Fund (40 percent).¹⁸ The Lottery also transfers about \$10 million annually to the state's General Fund for prizes not claimed after one year.¹⁹

As allowed by state statutes, the Minnesota State Lottery's procurement contracts are not subject to many of the state's statutory procurement requirements.²⁰ In addition, state statutes exempt the Lottery from some of the Department of Management and Budget's statutes relating to budgeting, payroll, and the purchase of goods and services; however, the Lottery is not exempt from other state requirements, such as policies related to internal controls and employee reimbursements.²¹

An independent certified public accounting firm annually audits the Lottery's financial statements. The Lottery received "clean" audit opinions for each of the past three years. A "clean" opinion indicates that the Lottery fairly presented balances and financial activities in accordance with generally accepted accounting principles.

Table 2 summarizes the Lottery's revenues, expenses, and changes in net position for fiscal years 2014 through 2016.

¹⁸ *Minnesota Statutes* 2015, 349A.10, subd. 5.

¹⁹ *Minnesota Statutes* 2015, 349A.08, subd. 5.

²⁰ *Minnesota Statutes* 2015, 349A.07, subd. 6, exempts the Lottery from certain sections in *Minnesota Statutes* 2015, 16C.

²¹ *Minnesota Statutes* 2015, 349A.10, subd. 3(d), exempts the Lottery from *Minnesota Statutes* 2015, 16A, related to budgeting, payroll, and purchase of goods and services.

Table 2
Statements of Revenues, Expenses, and Changes in Net Position
Fiscal Years 2014, 2015, and 2016
(in thousands)

	2014	2015	2016
<u>Operating Revenue:</u>			
Scratch Ticket Sales	\$351,912	\$376,196	\$394,762
Lotto Ticket Sales	179,604	170,672	198,091
Other Income	43	27	15
Total Operating Revenue	<u>531,559</u>	<u>546,895</u>	<u>592,868</u>
Less Payments In Lieu of Sales Tax	34,549	35,546	38,536
Gross Receipts	<u>\$497,010</u>	<u>\$511,349</u>	<u>\$554,332</u>
<u>Direct Costs:</u>			
Scratch Ticket Prizes	\$236,355	\$249,885	\$264,542
Lotto Ticket Prizes	91,637	85,313	101,358
Vendor Expenses	9,924	10,405	13,951
Ticket Costs	7,483	6,064	5,978
Retailer Commissions and Incentives	31,857	32,875	35,637
Total Direct Costs	<u>377,256</u>	<u>384,542</u>	<u>421,466</u>
Gross Profit	<u>\$119,754</u>	<u>\$126,807</u>	<u>\$132,866</u>
<u>Operating Expenses</u>			
Advertising	\$ 7,260	\$ 6,971	\$ 5,969
Salaries and Benefits	12,010	11,260	10,969
Promotions	1,385	1,304	2,279
Purchased Services	1,768	1,696	1,657
Communication	617	557	590
Occupancy Costs	1,585	1,469	1,568
Supplies and Materials	1,157	879	963
Computers and Maintenance	359	437	466
Depreciation	686	660	598
Other Expenses	622	462	335
Total Operating Expenses	<u>27,449</u>	<u>25,695</u>	<u>25,394</u>
Operating Income	<u>\$ 92,305</u>	<u>\$101,112</u>	<u>\$107,472</u>
<u>Nonoperating Revenue (Expense)</u>			
Interest Earned on Investments	\$ 157	\$ 169	\$ 254
<u>Payments to the State:</u>			
Compulsive Gambling Contribution	(1,189)	(1,923)	(1,618)
Unclaimed Prizes to State	(9,589)	(11,698)	(8,769)
Net Proceeds to State	<u>(81,684)</u>	<u>(86,377)</u>	<u>(95,758)</u>
Total Nonoperating Expense	<u>(92,305)</u>	<u>(99,829)</u>	<u>(105,891)</u>
Change in Net Position ¹	<u>\$ 0</u>	<u>\$ 1,283</u>	<u>\$ 1,581</u>

¹ For fiscal years before 2015, the Lottery's Change in Net Position was zero because state statutes required the Lottery to pay to the state all revenues remaining after payments in lieu of sales tax, prize payouts, and operating costs. However, because of changes in governmental accounting standards related to employee pensions (Governmental Accounting Standards Board Statement 68) the Lottery restated its net position at the beginning of fiscal year 2015 to show a net pension liability of \$12,615,000. Further, as seen in the table above, starting in fiscal year 2015 the Lottery shows a Change in Net Position reflecting the increase (or decrease) related to its net pension liability for that year.

Source: Minnesota State Lottery staff provided the audited financial statements for the fiscal years ended June 30, 2014, 2015, and 2016.

Objectives, Scope, and Methodology

The objectives of our audit of the Minnesota State Lottery were to answer the following questions for the period of January 1, 2014, through February 29, 2016:

- Did the Minnesota State Lottery have adequate internal controls over its information systems?
- Did the Minnesota State Lottery have adequate internal controls over its financial operations?
- Did the Minnesota State Lottery comply with the legal requirements we selected for testing?
- Did the Minnesota State Lottery resolve the prior audit findings?²²

To meet the above objectives, we interviewed Lottery management and staff to gain an understanding of the Lottery's information technology and financial policies and procedures. We considered the risk of potential weaknesses surrounding the Lottery's computer systems and noncompliance with relevant legal requirements.

We reviewed the internal controls as of March 2016 in the following information technology areas:

- For its primary and backup data centers, where the Lottery houses the centralized computers and other equipment necessary for the Lottery's information technology needs, we reviewed who had physical access to the centers and observed the equipment to ensure the Lottery adequately:
 - Regulated the air temperature;
 - Monitored for smoke, fire, and water;
 - Provided the power supply, including backup power; and
 - Restricted access.
- We examined the internal controls over the Lottery's computer systems to prevent or detect processing errors or unauthorized access by reviewing the:
 - Process for configuring computer equipment;
 - Network system settings, including password settings, system administrator access, and user activity logs;
 - Process for granting people access to the systems and data; and
 - Process to identify and follow up on unauthorized access attempts, processing errors, or fraud.

²² Office of Legislative Auditor's Financial Audit Division Report 13-12, *Minnesota State Lottery*, issued June 20, 2013. See Appendix A for more detail.

- We examined the internal controls over changes to the computer systems to ensure employees only made modifications that were reviewed and authorized; we:
 - Reviewed employees' access to make changes to the systems; and
 - Tested a sample of system changes to ensure that an independent person reviewed and approved the changes.
- We examined the internal controls over data retention and the ability to restore data if a problem occurred with the Lottery's information systems; we:
 - Reviewed contingency planning documentation; and
 - Reviewed processes for backing up and storing system data.

Our information technology review did not examine controls related to the specific software the Lottery uses for its gaming and accounting systems.

We also obtained and analyzed the Lottery's accounting data for transactions between January 1, 2014, and February 29, 2016, to identify unusual trends or significant changes in the following financial operations and conducted specific tests for each area, including:

Revenues – Scratch and Lotto Ticket Sales, we:

- Verified retailers met the statutory qualifications,²³
- Accompanied Lottery sales representatives as they monitored retailers;
- Selected a sample of retailers and ensured the Lottery collected or paid the amounts shown in the gaming system and paid the correct commissions to retailers,²⁴ and
- Examined Lottery employees' access to not public information related to retailers.

Expenses

- *Payments In Lieu of Sales Tax:*
 - We ensured the Lottery staff correctly calculated and paid the Department of Revenue the amount required by state statute.²⁵

²³ Minnesota Statutes 2015, 349A.06, subd. 2.

²⁴ Minnesota Statutes 2015, 349A.16 requires the Lottery pay retailers "...at least one percent on the amount of each winning ticket cashed by that retailer."

²⁵ Minnesota Statutes 2015, 297A.65 and 297A.62, subd. 1.

- *Scratch and Lotto Ticket Prizes*, we:
 - Selected a sample of prize payouts and verified the Lottery complied with the statutory prize requirements;²⁶
 - Ensured the Lottery paid the correct percentage of gross receipts in prizes,²⁷ and
 - Ensured the Lottery withheld the correct percentage of state income taxes from the prize payouts and subsequently paid the withholdings to the Department of Revenue.²⁸
- *Salaries and Benefits* (payroll costs), we:
 - Selected a sample of Lottery employees and reviewed the Lottery's hiring and employee evaluation practices; and verified the Lottery conducted the required employee background checks²⁹
 - Analyzed employee pay, including the executive director's, to ensure the wages complied with union contracts, compensation plans, and state statutes;³⁰
 - Analyzed sick and vacation leave usage and followed up on any unusual trends;
 - Verified the appropriate supervisors approved employees' timesheets and that supervisors and payroll staff could not approve their own timesheets;
 - Selected and tested a sample of biweekly pay periods and reviewed the Lottery's procedure to validate payroll;
- *Selected Travel Costs*, we:
 - Reviewed expense reimbursement reports for the former executive director, former director of operations, employees receiving the largest reimbursements, and those that stayed at the former executive director's timeshare units; and
 - Ensured the above reimbursements complied with union contracts, compensation plans, and the Department of Management and Budget's travel policies.³¹
- *Payments to the State*, we:
 - Ensured the Lottery calculated and transferred the correct amount of unclaimed prizes to the state's General Fund;³² and

²⁶ Minnesota Statutes 2015, 349A.08.

²⁷ Minnesota Statutes 2015, 349A.10, subd. 2.

²⁸ Minnesota Statutes 2015, 290.92, subd. 29.

²⁹ Minnesota Statutes 2015, 349A.02, subd. 6.

³⁰ Minnesota Statutes 2015, 349A.02, subd. 1, establishes the Lottery director's salary at 95 percent of the governor's salary.

³¹ Department of Management and Budget Policy PAY0021, *Employee Business/Travel Expenses*.

³² Minnesota Statutes 2015, 349A.08, subd. 5.

- Ensured the Lottery calculated and transferred the correct amount of net proceeds to the General Fund and the Environment and Natural Resources Trust Fund.³³

We also ensured the Lottery's internal controls safeguarded its cash in the bank by reviewing:

- Reconciliations between the bank statements and the accounting system and between the accounting and gaming systems;
- Which employees had online access to the Lottery's bank accounts and could initiate and approve electronic fund transfers; and
- The Lottery's weekly process for drawing down funds from the state treasury into its local bank account.³⁴

We conducted the audit in accordance with generally accepted government auditing standards.³⁵ Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

We used various criteria to evaluate internal controls and compliance. We used, as our criteria to evaluate internal controls, the guidance contained in the *Standards of Internal Control in the Federal Government*, published by the Government Accountability Office in September 2014.³⁶ When assessing internal controls over information technology systems, we assessed the Lottery's internal controls against the information technology standards of the National Institute of Standards and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations*, published by the U.S. Department of Commerce in April 2013.³⁷ Finally, we used state laws, regulations, and contracts, as well as policies and procedures established by the Lottery and the Department of Management and Budget to evaluate compliance.

³³ Minnesota Statutes 2015, 349A.10, subd. 5.

³⁴ Minnesota Statutes 2015, 349A.10, subd. 7.

³⁵ U.S. Government Accountability Office, *Government Auditing Standards*, December 2011.

³⁶ The state adopted these standards as its internal control framework for the executive branch. See the Department of Management and Budget Statewide Operating Policy, 0102-01, *Internal Control System*.

³⁷ The National Institute of Science and Technology Special Publication 800-53 provides information technology standards for the federal government. These standards are widely accepted security standards and guidelines and are not only used by the federal government, but are frequently adopted on a voluntary basis by many organizations in the private sector. We used these to assess the Lottery's information technology environment, in the absence of the Lottery's use of other standards as a basis for its operations.

Conclusions

The Minnesota State Lottery had generally adequate internal controls over its information technology, but it had some weaknesses as noted in Findings 1 through 7.

The Minnesota State Lottery had generally adequate internal controls over its financial activities, but it had some weaknesses as noted in Findings 7 through 9.

The Minnesota State Lottery generally complied with the legal requirements we tested, except as stated in Finding 8. In addition, we provide an analysis in Appendix A of two prior Lottery practices we think are legally questionable. The Lottery ended both practices on July 1, 2016.

The Minnesota State Lottery resolved five prior audit findings, as shown in Appendix B.

Findings and Recommendations

The Minnesota State Lottery did not have sufficient formal, documented policies and procedures for all information technology control areas.

Finding 1

The Lottery had not sufficiently documented its policies and procedures for a number of areas that increase the risk of an ineffective information technology environment. For example, the Lottery had not sufficiently documented its policies and procedures to ensure that employees made only authorized and tested changes to its systems, or to limit employee access to the information technology system to only those functions necessary for the employee to perform work assignments. General information technology standards suggest that documented policies and procedures are necessary to effectively implement and maintain internal controls.³⁸ Policies and procedures reflect commonly accepted information technology practices and management's expectations for the Lottery's operations.

The Lottery had not sufficiently documented policies and procedures for the following areas:

- Monitoring and auditing user activity on the Lottery's information system network to detect unauthorized or inappropriate attempts to access sensitive or not public information.
- Periodically reviewing users' access to information systems to ensure that access is appropriate for the users' job functions.
- Making changes to systems to ensure that employees only make authorized changes.
- Administering changes to the firewall settings to reduce the risk of unauthorized access to the systems and data by persons outside of the Lottery.
- Assessing information technology risks to the Lottery's mission, functions, and reputation to (1) identify threats, (2) reduce or eliminate

³⁸ April 2013, National Institute of Science and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations*, RA-1, Risk Assessment Policy and Procedures; CA-1, Security Assessment and Authorization Policies and Procedures; CA-2; Security Assessments; AT-1, Security Awareness and Training Policy and Procedures; AT-2, Security Awareness Training; AU-1, Audit and Accountability Policy and Procedures; AU-2, Audit Events; IA-11, Re-Authentication; CM-1, Configuration Management Policy and Procedures; CM-2, Baseline Configuration; CM-3, Configuration Change Control; CM-5, Access Restrictions for Change; CM-6, Configuration Settings; CM-9, Configuration Management Plan; CM-11, User-Installed Software; AC-1, Access Control Policy and Procedures; AC-2, Account Management; AC-3, Access Enforcement; AU-6, Audit Review, Analysis, and Reporting.

these threats, and (3) train employees about these threats and how to avoid them.

- Managing and monitoring of software on Lottery computers to reduce the risk that employees change the standard structure of its information technology systems.

Formally documented policies and procedures help establish the overall tone for an organization by establishing the steps needed to perform business functions and by providing a way to monitor whether employees complete all necessary parts of the business processes. Policies and procedures also help to maintain continuity of processes as employees change job roles over time. Without documented policies and procedures, employee turnover could result in the loss of organizational knowledge.

Policies and procedures are necessary because they eliminate confusion, create structure, and enforce uniform standards among employees. They are most effective when clearly documented and communicated to employees. If the Lottery had developed policies and procedures to address these types of risks, it may have avoided weaknesses noted in Findings 2, 4, and 7 in this report.

Recommendations

- *The Minnesota State Lottery should develop and improve its formal, documented policies and procedures for its information technology processes.*
- *The Minnesota State Lottery should train information technology employees on its information technology policies and procedures where appropriate for their job functions.*

Finding 2

The Minnesota State Lottery did not always have sufficient evidence of the review and approval of changes made to its computer systems.

Good information technology controls require that an independent person review program changes to the computer systems and provide evidence they approved the changes. Generally, organizations create formal change management processes to ensure employees introduce changes to the functionality of a system in a controlled and coordinated manner. The change management process typically includes controls to ensure employees properly request, review and test, approve, and implement changes. Good information technology controls require that the organization document the completion of these steps.³⁹ By not having a

³⁹ April 2013, National Institute of Science and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations*, AU-6, Audit Review, Analysis, and Reporting; CM-3, Configuration Change Control; CM-5, Access Restrictions for Change.

sufficiently documented change management policy and procedure, as discussed in Finding 1, the Lottery risked employees introducing unnecessary or unauthorized changes into a system, which could result in system errors or disruption of information systems operations.

The Lottery did not consistently document the approval of system changes. In 5 of the 25 system changes we tested, an employee made changes to the computer system without evidence that an independent person reviewed and approved the changes. Without this evidence, the Lottery could not ensure the changes were necessary and appropriate.

Recommendation

- *The Minnesota State Lottery should ensure that a person independent of the individual making the change reviews and approves all system changes and documents the review and approval.*

The Minnesota State Lottery did not have an adequate plan to recover its information technology operations in the event of a disaster.

Finding 3

Good information technology controls require that organizations develop and document a formal disaster recovery plan to assist the organization in recovering its critical operations in a timely manner. The plan is necessary to guide an organization in its response to an adverse or disaster event, such as flooding of the data center, a power outage, security breach, or tornado touchdown. In addition to developing a plan, good controls require the organization to train employees on implementing the plan, and periodically test and update the plan.⁴⁰

The Lottery did not document a formal disaster recovery plan or conduct and document a business impact analysis. This analysis assesses the vital business areas and resources of the organization and the impact to these areas and the overall business in the event of a disaster. Because the Lottery did not document a formal disaster recovery plan, it was not able to (1) train its employees, (2) test the steps needed to recover operations, and (3) allocate its resources in the event of a disaster. For example, the Lottery did not have the necessary hardware or software at its backup data center to recover its accounting system. If the Lottery had attempted to practice recovering from a disaster, it would know the impact a disaster would have on its accounting operations and whether it needed to reallocate resources and update its plan.

⁴⁰ April 2013, National Institute of Science and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations*, CP-2, Contingency Plan; CP-3, Contingency Training; CP-4, Contingency Plan Testing; CP-7, Alternate Processing Site; CP-9, Information System Backup.

Recommendations

- *The Minnesota State Lottery should develop a formal, documented disaster recovery plan to enable the timely recovery of critical business processes, including information systems operations and data.*
- *The Minnesota State Lottery should distribute the disaster recovery plan to appropriate employees and provide training.*
- *The Minnesota State Lottery should periodically test its disaster recovery plan to ensure the effectiveness of the plan and identify needed updates.*

Finding 4**The Minnesota State Lottery did not periodically ensure it appropriately limited people's access to its information systems and physical facilities.**

Good controls require that an organization restrict access to its information systems and physical facilities to only those people who require such access for the routine performance of their job functions. In addition, because peoples' responsibilities change over time, the controls require an organization to review this access periodically to determine whether people still need the access.⁴¹

In March 2016, Lottery staff told us they had no process to periodically review users' access to their computer systems and did not regularly review this access. In addition, as of March 2016, 47 employees, contractors, or vendors had access to the doors for the primary data center, and 40 had access to the backup data center.⁴² After we brought this information to management's attention, the Lottery reviewed and reduced the access to the primary and backup data centers. By not periodically reviewing the access to its information systems and physical facilities, the Lottery risked people having unnecessary access and potentially misusing or disrupting its information systems.

Recommendation

- *The Minnesota State Lottery should periodically review access to its information systems and data centers and restrict access to only those people who need the access to perform their job functions.*

⁴¹ April 2013, National Institute of Science and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations*, AC-6, Least Privilege; CA-7, Continuous Monitoring.

⁴² A data center is an area within an organization's facilities that houses the computer equipment and networking systems and components for the organization's information technology needs.

The Minnesota State Lottery's information systems did not require complex passwords for users to log onto the Lottery's systems.**Finding 5**

Good information technology controls require that users create complex passwords (a combination of upper and lower-case letters, numbers, and/or special characters).⁴³ Users (employees, contractors, and vendors) must enter a valid user ID and password to gain access to the Lottery's systems.

We reviewed the systems' password parameters and found the Lottery had not implemented the complex password setting. Without complex passwords, the Lottery risked people, including hackers, guessing users' passwords to gain unauthorized access to its systems.

Recommendation

- *The Minnesota State Lottery should implement the system setting requiring complex passwords.*

The Minnesota State Lottery did not document a formal, organization-wide plan to respond to security incidents.**Finding 6**

The Lottery did not have an overall plan or process to identify and respond to security incidents. Security incidents are adverse events related to the security of computer systems or networks, such as:

- loss or theft of a laptop,
- downloading unauthorized software,
- accidental file deletion, or
- attempts to breach computer systems.

Good information technology controls require that organizations develop formal plans for responding to security incidents, and that these plans be communicated to employees.⁴⁴ Organizations use a documented incident response plan to prepare for disruptive security events from external and internal sources, minimize the impacts to their business functions, and maintain or restore their business functions.

While Lottery staff in some departments had processes to identify and respond to security incidents, the lack of an overall documented plan may result in

⁴³ April 2013, National Institute of Science and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations* IA-5, Authenticator Management; IA-11, Re-Authentication; AC-2, Account Management.

⁴⁴ April 2013, National Institute of Science and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations*, IR-1, Incident Response Policy and Procedures; IR-2, Incident Response Training; IR-8, Incident Response Plan.

unidentified and unreported security incidents, and responses inconsistent with management's expectations.

Recommendation

- *The Minnesota State Lottery should develop and document an organization-wide incident response plan and communicate the plan to employees.*

Finding 7

The Minnesota State Lottery did not adequately limit employee access to retailers' not public information.

The Lottery gave about 50 employees access to view retailers' banking information through its gaming system and kept paper copies of the retailers' banking information and social security numbers in unlocked and unattended file cabinets.⁴⁵

The Lottery contracts with retailers to sell Lottery tickets and pay prizes less than \$600. The Lottery uses the retailer banking information to electronically transfer money between the Lottery's and retailers' bank accounts. If a retailer collects more in ticket sales than it paid out in prizes, the Lottery transfers funds from the retailer's account into the Lottery's account. Conversely, if the retailer paid out more in prizes than it collected, the Lottery transfers funds into the retailer's bank account.

Gaming System Access

The Lottery gave various employees access to view retailer banking information, and Lottery staff agreed many of those employees did not have a business need to see the information. The gaming system screen containing the retailer banking information displayed other retailer information, including retailer name, contact information, and billing details. The Lottery allowed employees from many divisions (including executive, information systems, research and planning, sales, and security employees) the ability to view the banking information. Although these employees may have had a business need to see the other retailer information, they did not need to view the banking information.

Good information technology controls say organizations should only give users access to data which are necessary to accomplish their assigned tasks in accordance with the organization's mission and business functions.⁴⁶ In addition,

⁴⁵ Minnesota Statutes 2015, 13.37 subd. 1(a) and 13.355 classifies checking account numbers and social security numbers as not public information.

⁴⁶ April 2013, National Institute of Science and Technology Special Publication 800-53 (Revision 4) *Security and Privacy Controls for Federal Information Systems and Organizations*, AC-6, Least Privilege.

as discussed previously in Finding 4, organizations should periodically review the access given to users and ensure the users continue to need the access. The Lottery, however, did not perform these types of periodic reviews.

Because the Lottery maintains more not public information than just retailer banking information in its gaming and other computer systems, such as prize winner information and location of winning scratch tickets, it should periodically assess whether users with access to view not public information in all its computer systems continue to have a business need to see the information.

File Cabinet Access

The Lottery did not adequately secure file cabinets that stored retailer documents containing not public information, including retailer owners and partners' social security numbers and banking information. The Lottery staff told us the cabinets were locked at night and open during the day; however, we observed the cabinets unlocked as early as 6:00 a.m. and as late as 5:00 p.m. In addition, the location of the cabinets did not allow Lottery staff to easily see if an unauthorized person accessed the files, and any employee, contractor, and visitor with access to the secured entry of the building had access to the cabinets. State statutes require organizations to establish appropriate security safeguards for all records containing data on individuals, and only allow employees with a business need to have access to not public information.⁴⁷

If the Lottery does not secure not public information from those without a business need and periodically verify that computer system users continue to need access to the not public information, it increases the risk of an unauthorized employee inappropriately using the information.

Recommendations

- *The Minnesota State Lottery should review all the not public information in its computer systems and ensure only those employees with a business need can view the information.*
- *The Minnesota State Lottery should secure physical documents that contain retailers' not public information to ensure only employees with a business need have access to them.*

The Minnesota State Lottery did not fingerprint and conduct all required background checks for its temporary employees.

Finding 8

Although the Lottery conducted the Minnesota criminal background checks on all 105 employees it hired from January 1, 2014, and February 29, 2016, including

⁴⁷ Minnesota Statutes 2015, 13.05, subd. 5(2).

50 temporary employees, it did not fingerprint any of the temporary employees hired to help with special events, such as the Minnesota State Fair and WE Fest.⁴⁸

State statutes prohibit the Lottery from hiring employees convicted of a felony or crime involving fraud or misrepresentation within five years of starting employment or hiring anyone convicted of a gambling-related offense. State statutes further require the Lottery conduct background checks and fingerprint all employees.⁴⁹ The Lottery submits the potential employee's personal information and fingerprint scans to the Minnesota Department of Public Safety, and Public Safety conducts two background checks:

- the Minnesota background check identifies if the employee had a criminal record in Minnesota, and
- the Federal Bureau of Investigation (FBI) background check uses the employee's fingerprint scan to identify if the employee had a criminal history in another state.

Because the verification done by the FBI takes more time than the Minnesota background check, the Lottery often received the FBI results from Public Safety a month or more after the Lottery submitted the fingerprint scans.

The Lottery did not fingerprint temporary employees because it generally hired the temporary employees only a few days before the event started, and it could not receive the FBI results until after the event ended. However, if the Lottery had hired the employees earlier, it would have had sufficient time to receive the FBI results before the event began and could ensure the employees did not have a criminal offense that disqualified them from being a Lottery employee.

Recommendation

- *The Minnesota State Lottery should fingerprint temporary employees and begin the hiring process early enough to conduct all the required criminal background checks.*

Finding 9

The Minnesota State Lottery did not verify whether retailer owners and partners were Lottery employees or family members living in the employees' households.

We verified that the owner or partners of 79 Lottery retailers (36 privately owned and 19 corporate owners, such as Kwik Trip) were not employees or family members living with an employee; however, Lottery staff did not do a similar verification.

⁴⁸ WE Fest is a country music festival held annually in Detroit Lakes, Minnesota. The Lottery sells tickets and allows winners to redeem smaller prizes during the event.

⁴⁹ Minnesota Statutes 2015, 349A.02, subd. 6.

State statutes prohibit the Lottery from contracting with a retailer if the retailer “is a member of the immediate family, residing in the same household, as the director or any employee of the lottery.”⁵⁰ In addition, the Lottery’s code of conduct prohibits employees from having a financial interest in a retailer and requires the employees to certify they agree to abide by the code.

The Lottery requires new retailers to complete an application and submit an annual renewal application. These applications require retailers to certify whether:

- “the retailer’s owner or partners have an immediate family member living in the same household who is: the director of the Lottery, or an employee of the Minnesota State Lottery;” and
- “the business [is] owned in whole or in part by: a Minnesota State Lottery employee, or director, or one of their immediate family members residing in the same household.”

The Lottery maintained a list of employees and their live-in family members and used the list to ensure prize winners were not on the list.⁵¹ However, no one at the Lottery compared the retailer owners and partners to this list. The Lottery staff we interviewed assumed that staff in a different division did the verification. The Lottery had a written procedure for processing a retailer application, but the procedure did not include a step to verify the owners and partners were not Lottery employees or family members living with them. The omission likely contributed to the confusion Lottery staff had on who was responsible to do the verification.

Recommendations

- *The Minnesota State Lottery should verify that retailer owners and partners are not Lottery employees or family members residing in the same household.*
- *The Minnesota State Lottery should update its procedure for processing a retailer application and clearly define who is responsible to verify retailers meet the qualifications outlined in state statute.*

⁵⁰ Minnesota Statutes 2015, 349A.06, subd. 2(a)(5).

⁵¹ Minnesota Statutes 2015, 349A.08, subd. 7, prohibits the Lottery from paying prizes to the director, an employee, or their family members residing in the same household.

Appendix A: Memorandum to Legislators

While conducting our audit of the Lottery, we identified three issues that need legislative attention. The issues involve questions about how state laws affect certain Lottery practices.

As discussed in the analysis that follows, we believe the Legislature needs to clarify the laws.

In addition to including the analysis in this report, we will send it separately to legislators on House and Senate committees with jurisdiction over the Minnesota Lottery.

Elizabeth Stawicki, OLA's Legal Counsel, researched and wrote the analysis.



OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

Date: November 4, 2016

To: Members of the Senate Commerce Committee
Members of the House Commerce and Regulatory Committee

From: James Nobles, Legislative Auditor 

Subject: Questions Concerning State Laws and the Minnesota State Lottery

The following document discusses several laws that govern the operations of the Minnesota State Lottery. Elizabeth Stawicki, OLA's Legal Counsel, prepared the document.

I believe Ms. Stawicki's analysis demonstrates that the laws involved need legislative discussion and clarification.

Please feel free to contact Ms. Stawicki or me if you have questions or want additional information.

**State of Minnesota
Office of the Legislative Auditor**

Legal Issues Related to Minnesota State Lottery

INTRODUCTION

During our recent audit of the Minnesota State Lottery, we questioned the legal basis for two prior Lottery practices. First, we questioned the Lottery's practice of facilitating the transfer of winning tickets by affidavit. Second, we questioned the Lottery's practice of offering "Second Chance" promotional prizes with claim periods of less than one year.

Although Lottery officials ended both practices in response to our questions, they did not agree with our interpretation of the relevant state laws. Therefore, we decided to bring the issues to the attention of legislators. In this document, we present the questions we raised about the Lottery's two practices, our position on each question in a short answer, followed by a longer analysis. We recommend that the Legislature clarify the laws involved with both issues.

In the final section, we discuss another legal issue that arose during our audit: the conflict between two laws governing whether the Lottery may award a prize to a person under age 18. Again, we recommend that the Legislature clarify the law involved with this issue.

TRANSFERRING WINNING TICKETS AND OFFERING SECOND CHANCE GAMES WITH CLAIM PERIODS OF LESS THAN ONE YEAR

QUESTIONS

- I. Does the Lottery's practice of allowing the transfer of ticket ownership violate the state's ban on assigning lottery prizes (*Minnesota Statutes 2016, 349A.08, subd. 2*)?
- II. Does the Lottery's practice of offering certain "Second Chance" prizes violate *Minnesota Statutes 2016, 349A.08, subd. 5*, if the Lottery (1) gives Second Chance winners less than "within a year" to collect their prizes, and (2) awards a prize to a second winner if the first forfeits?

SHORT ANSWERS

- I. There does not appear to be a clear-cut answer. A court could narrowly read the anti-assignment clause as applying to prizes only. On the other hand, a court could view the Lottery's affidavit form as circumventing the spirit of the law. The Legislature

should consider clarifying *Minnesota Statutes* 2016, 349A.08, subd. 2, particularly to determine whether it may conflict with the Uniform Commercial Code (UCC).

- II. The Lottery's prior Second Chance promotion games appeared to violate the unclaimed prizes statute. The Legislature should also consider clarifying whether *Minnesota Statutes* 2016, 349A.08, subd. 5, also applies to Second Chance promotion games.

ANALYSIS – QUESTION I

Does the Lottery's practice of allowing the transfer of ticket ownership violate the state's ban on assigning lottery prizes (*Minnesota Statutes* 2016, 349A.08, subd. 2)?

BACKGROUND

An amendment to the Minnesota Constitution in 1988 allowed the state to operate “a lottery and sale of lottery tickets....”¹

With few exceptions, Minnesota law does not allow a person to “assign,” that is, transfer the rights of a lottery prize to another person.² Those exceptions include:

1. If a prize winner dies before the prize is paid, the director shall pay the prize to the prize winner’s estate, and
2. The director may pay a prize to a person other than the winner of that prize under an appropriate court order.³

Nonetheless, the Lottery allowed the transfer of a winning ticket from one person to another through its “Affidavit of Ticket Ownership.”⁴ The original owner of the ticket signed the affidavit, which gave permission for a subsequent person to cross the original owner’s name off the ticket. The affidavit also required the original owner to:

[R]elinquish any and all rights that I may have had in said ticket and agree that the Minnesota State Lottery is relieved from any liability owed to me from any prize due to me from said ticket.⁵

The Lottery contended it was not violating the statute, but stopped transferring winning tickets by affidavit on July 1, 2016.⁶

¹ *Minnesota Constitution*, amend. XIII, sec. 5.

² *Minnesota Statutes* 2016, 349A.08, subd. 2. See also Bryan A. Garner, Editor in Chief, *Black’s Law Dictionary* (St. Paul: Thomson Reuters, 2014), 142.

³ *Ibid.*

⁴ Exhibit 1, located on page A-17 of this section.

⁵ *Ibid.*

⁶ Benjamin Freedland, General Counsel, Minnesota Lottery, memorandum to Executive Team, *Lottery Prize Policy Changes*, June 21, 2016.

DISCUSSION

Minnesota and other state courts have held generally that contract law governs a lottery winner's entitlement to a prize.⁷ A lottery offers a chance to win a prize; the player accepts the offer by purchasing a lottery ticket. In addition to an offer and acceptance, a valid contract (and lottery) requires a bargained-for exchange of something of value known legally as "consideration."⁸ Here, the player pays money to the Lottery for a chance to win a prize. If the player's ticket contains the winning numbers (and is valid), the Lottery gives the player the prize.⁹

Minnesota's courts have held that contract rights are generally assignable, except where the assignment is (1) prohibited by statute, (2) prohibited by contract, or (3) where the contract involves a matter of personal trust or confidence.¹⁰ In this instance, a statute prohibits assigning lottery prizes.

A. Exact Legislative Intent for the Anti-Assignment Clause is Unclear

It is unclear exactly what the Legislature's intent was behind enacting the anti-assignment clause.¹¹ It appeared in bills in Minnesota in 1987,¹² which the Legislature ultimately passed in 1989.¹³ Unfortunately, audio tapes of the committee hearings discussing the legislation no longer exist. Moreover, we could not find a discussion of the clause in a scan of committee reports or minutes.

⁷ *Littlewolf v. Girard*, 607 N.W.2d 464, 467 (2000) citing *Coleman v. State*, 77 Mich. App. 349, 258 N.W.2d 84, 86 (Mich. Ct. App. 1977) (lottery winner's entitlement to a prize is governed by principles of contract law); *Jackson v. Conn. Lottery Corp.*, CV 970483674S, 1998 Conn. Super. LEXIS 2562 (Super. Ct. Sep. 4, 1998) (breach of the contract by the failure of the lottery winner to present the ticket within the one-year period was a material breach, which excused the performance of the commission).

⁸ *Minnesota Souvenir Milkcaps, LLC v. State of Minnesota*, 687 N.W.2d 400, 403 (Minn. Ct. App. 2004) review denied (Minn. Dec. 22, 2004) (a lottery exists if (1) a prize or reward is offered, (2) chance determines who is awarded the prize, and (3) participants pay consideration for the chance to win the prize). See also 18 USCS, sec. 1301, note 5 (2016).

⁹ *Minnesota Rules*, 7857.4000, posted April 2, 1990 ("Upon validation by the lottery, a check will be forwarded to the claimant in payment of the amount due subject to the restrictions of payment provided by law.").

¹⁰ *Travertine Corp. v. Lexington-Silverwood, Ltd. Partnership*, 683 N.W.2d 267, 270 (Minn. 2004).

¹¹ We could find no mention of the anti-assignment clause in the Report of the Governor's Commission on the Lottery. Gene A. Bier, Chair, Governor's Commission on the Lottery, *Report of the Governor's Commission on the Lottery* (St. Paul, 1989). There was also no mention of the clause in an implementation and operation guide prepared for Minnesota. GTECH Corporation, *The Lottery Source Book – A Comprehensive Guide for Minnesota Policymakers* (Providence, RI, 1988).

¹² S.F. 937, 1987 Leg., 75th Sess. (MN).

¹³ *Laws of Minnesota* 1989, chapter 334, art. 3, sec. 8, subd. 2.

A *Statement of Need and Reasonableness* (SONAR) in 1990, however, provides some insight.¹⁴ In it, the Lottery director explains the rationale behind the rule based on the statute's anti-assignment clause.¹⁵

If persons were allowed to circumvent this prohibition [against assigning a prize to another] the person might be susceptible to unscrupulous individuals who may attempt to buy the prize, which is normally to be paid over time, for an immediate payment up front which is for less than the value of the prize. Further, if the Internal Revenue Service determined that prizes could be readily assigned then they would tax the full value of the prize at the time it is won, not in each year that the prize is normally received. This possible interpretation by the I.R.S. would be extremely detrimental to winners who did not assign their prize.¹⁶

We followed up with Dale McDonnell, the Lottery's first legal counsel and John Williams, House Research analyst, who authored a report on the evolution of gambling in Minnesota.¹⁷ They told us that drafters likely modeled Minnesota's anti-assignment language after other states that had already enacted their lotteries. We asked them what their recollections were of why Minnesota enacted its language and we received various answers.

One repeated the reason in the SONAR. The provision was to protect winners from out of state predatory investors and annuity sellers who would convince lottery winners to sell their prizes for pennies on the dollar in order to get their cash up front. During the 1980s and 1990s, most winners of large payouts did not have the option of obtaining a cash lump sum, as is the norm now; winners had to collect large prizes in installments.¹⁸ This is no longer an issue because the rules changed in August 1999 allowing winners the option of a lump sum payment.¹⁹

Other reasons for the clause we heard: to prevent evasion of the provisions of section 349A.08 that prohibited payment of prizes to certain persons—lottery employees, lottery vendors, and

¹⁴ Minnesota Statutes 2016, 14.131, requires an agency to prepare, review and make available for public review a statement of the need for reasonableness of the rule. It must be prepared under rules adopted by the chief administrative law judge and must include at least eight requirements.

¹⁵ Minnesota Rules, 7857.6020, posted April 2, 1990 ("Prizes in the lottery are not assignable except: A. if the prize winner dies before the prize is paid the director shall pay the prize as required under law; or B. Pursuant to an appropriate court order, which order shall not include an order issued to enforce or approve an agreement between a prize winner and any third party where the prize winner has agreed to transfer future prize payments to a third party in exchange for consideration.").

¹⁶ George R. Andersen, Director, Minnesota State Lottery, *In the Matter of the Proposed Adoption of Rules Relating to Lottery Prize Payments – Statement of Need and Reasonableness* (St. Paul, 1990).

¹⁷ John Williams, Legislative Analyst, House Research Department, *Gambling in Minnesota – A Short History*, (St. Paul, 2005).

¹⁸ This reason also appears in other state lottery histories, for example, Illinois, which enacted its lottery in 1973, contains a similar anti-assignment clause. The purpose of "Illinois' general prohibition against the assignment of lottery winnings 'evidences the State's desire to exercise its *parens patriae* protection of lottery winners.'" *Singer Asset Fin. Co. v. Duboff Family Inv. (In re Duboff)*, 290 B.R. 652 (Bankr. C.D. Ill. 2003) citing *Midland States Life Ins. Co. v. Hamideh*, 311 Ill.App.3d 127, 134 (1999). See The Motley Fool, 2002 WL 24368152 ("Most lottery winners can't handle their sudden wealth. A third of them end up bankrupt.").

¹⁹ Minnesota Rules, 7857.4040, posted August 2, 1999.

persons delinquent in state taxes or child support. If prizes were assignable, a person could bypass these prohibitions by assigning a prize to another person in a clandestine prize-sharing arrangement.

In addition, on an administrative level, the language may have been intended to address situations where several persons (dozens potentially) owned an interest in a winning ticket. The anti-assignment clause allowed the lottery to pay a prize to a single person rather than a consortium. Conceivably any member of the consortium could sue if they were unhappy with the division of the prize, and include the lottery as a defendant.

B. Arguments for the Lottery's Position

1. The Statute is Clear—Assignment Refers to Prizes Only

The Lottery argues that the statute is clear and unambiguous—"A prize is not assignable...." While the statute prohibits assigning a "prize," it says nothing about prohibiting a "ticket." In addition, *Minnesota Rules* say, "Prizes in the lottery are not assignable...."²⁰ There is no mention of a ticket in the anti-assignability section.

The Lottery contends that because its affidavit transfers or assigns ownership of a *ticket*, it is not violating the statute. At that point, there is no prize since no one had made a claim. Once a person has made the claim and the Lottery determines the person is entitled to the prize, the anti-assignment clause then attaches to the person.

This reasoning follows the Minnesota Court of Appeal's determination of when earnings for tax purposes attach to a lottery ticket. In *Littlewolf v. Girard*, the question was whether Paula Littlewolf, a resident of the White Earth Reservation, had to pay state income tax on winning a "High Stakes II" instant game ticket that she purchased at a store within the reservation boundaries.²¹ She argued that the state of Minnesota lacked jurisdiction to tax her on the \$100,000 winnings because she was a tribal person living on a reservation who earned the income within the bounds of the reservation.²²

The three-judge panel disagreed. The panel ruled that Littlewolf earned her winnings by agreement "when she presented her ticket and the claim form, and completed the validation and verification procedures at the lottery headquarters in Roseville."²³ Because she earned her lottery winnings income off the reservation, she was subject to state income tax.²⁴

²⁰ *Minnesota Rules*, 7857.6020, posted April 2, 1990.

²¹ *Littlewolf*, 607 N.W.2d 465. State income tax on the \$100,000 prize amounted to \$8000; federal income tax amounted to \$28,000.

²² *Ibid.*, at 465-66.

²³ *Ibid.*, at 467. See *Ramirez v. Bureau of State Lottery*, 186 Mich. App. 275, 463 N.W.2d 245, 247 (Mich. Ct. App. 1990) (presentment of winning ticket is a condition precedent to winning the prize), appeal denied, 475 N.W.2d 819 (Mich. Oct. 4, 1991); *Coleman v. State*, 77 Mich. App. 349, 258 N.W.2d 84, 86 (Mich. Ct. App. 1977) (lottery winner's entitlement to a prize is governed by principles of contract law); *Karafa v. New Jersey State Lottery Comm'n*, 129 N.J. Super. 499, 324 A.2d 97, 99 (N.J. Super. 1974) (regulations of state lottery must be followed in order to receive prize).

²⁴ *Littlewolf*, at 466.

A court could agree with the Lottery's position that taken literally, the plain language refers only to prizes but not tickets. Moreover, the statute does mention "winning ticket" in two places under the Lottery Prize section. Therefore, if the Legislature wanted to include tickets or winning tickets in the not assignable section, it would have. It did not. A court could stop there.

2. Bearer Instruments

The Lottery also argues that it allows transfers of ticket ownership because lottery tickets are bearer instruments. A bearer instrument means that whoever holds it is entitled to its underlying value, for example like having a \$10 bill in your pocket. The Lottery encourages the holder to sign it immediately upon purchase so that another person cannot take legal possession of it. The Lottery says Minnesotans frequently purchase lottery tickets as gifts and therefore the affidavit helps facilitate that gift. Nevertheless, a person who bought the ticket could accomplish transferring the winning ticket claim without the Lottery's affidavit by simply giving the unsigned ticket to another person to sign.

3. Some other state laws prohibiting the transfer of lottery tickets include language similar to "the right to a prize," which is absent from Minnesota's anti-assignment clause.

While the Lottery did not make the following argument, it could argue that Minnesota's anti-assignment clause, which does not include the *right* to a prize, further supports its position that the clause only applies to prizes, not tickets, even winning tickets.

Some other state lottery anti-assignment statutes not only bar assignments to lottery *prizes* but also the *right* to prizes. The right to a prize could conceivably include a winning ticket. At least five state lottery statutes have similar anti-assignment clauses but they also include a key phrase (emphasis added) absent from Minnesota's statute. For example:

- Illinois – "No prize, nor any portion of a prize, *nor any right of any person to a prize* awarded shall be assignable."²⁵
- Kentucky – "No prize, nor any portion of either a prize, *nor any right of any person to a prize* awarded shall be assignable except as provided in subsection (6) of this section."²⁶ (Subsection 6 says prizes may be voluntarily assigned if by court order).
- New Jersey – "*The right of any person to a prize* drawn shall not be assignable, except as permitted by this section."²⁷
- Washington – "*No right of any person to a prize* drawn is assignable, except that payment of any prize drawn may be paid to the estate of a deceased prize winner, and except that

²⁵ 20 Illinois Compiled Statutes 2016, 1605, sec. 13.

²⁶ Kentucky Statutes 2016, 154A.110, subd. 2(a), 6.

²⁷ New Jersey Statutes 2016, Title 5, chapter 9(a).

any person pursuant to an appropriate judicial order may be paid the prize to which the winner is entitled.”²⁸

- Wyoming – “*No prize, any portion of a prize or any right of any person to a prize awarded shall be assignable.*”²⁹

It is unclear whether the Legislature considered adding “the right” of a person to a prize to the assignment section and if so, why it did not include it. If the Legislature did not consider it, however, doing so would tighten up the language.

C. Arguments Against the Lottery’s Position

1. To transfer the winning ticket is to transfer the prize.

The Lottery’s argument that there is a distinction between transferring a ticket and transferring a prize is true only if the ticket is a losing ticket. The affidavit transfers a *winning* ticket, not a losing one. According to Minnesota Lottery Rules, “When a name is placed in the designated area, the person whose name appears in that area is the owner of the ticket and *is entitled to any prize attributable to that ticket* (emphasis added).”³⁰ The Lottery’s affidavit also specifically refers to the ticket as the winning ticket. The original holder turns the ticket over to the new ticket holder “*to claim the prize* at the Minnesota State Lottery....” A winning ticket is inextricably linked to the prize. Consequently, there is no meaningful distinction between a winning ticket and the lottery prize. Therefore, the anti-assignability clause applies to winning tickets.

2. Minnesota Statutes and Minnesota Rules narrowly construe the exceptions to barring assignment of lottery prizes.

Minnesota Statutes list only two exceptions to 349A.08, subd. 2. They allow assignment to the winner’s estate if the winner dies before collecting the winnings and it allows assignment by “appropriate court order.”³¹ Neither the statute nor the rules list an exception that allows the Lottery to assign or transfer the prize by affidavit. By transferring ownership of a winning ticket, however, the Lottery is facilitating an assignment from one person to another bypassing a court order or the statute.

In addition, lottery regulations narrowly construe the court approval exception. A court order cannot approve an agreement between a prizewinner and a third party if the winner has agreed to transfer future prize payments (such as installments) to the third party in exchange for

²⁸ *Annotated Revised Code of Washington* 2016, 67.70.100(1).

²⁹ *Wyoming Statutes* 2016, 9-17-119, subd. (b)(i).

³⁰ *Minnesota Rules*, 7857.5000, posted April 2, 1990.

³¹ *Ibid.*; *Minnesota Rules*, 7857.6020(B), posted April 2, 1990 (“pursuant to an appropriate court order, which order shall not include an order issued to enforce or approve an agreement between a prize winner and any third party where the prize winner has agreed to transfer future prize payments to a third party in exchange for consideration”).

consideration.³² This contrasts with states such as Massachusetts that do allow courts to grant voluntary assignments in some situations.³³

3. The Lottery's affidavit appears to circumvent the spirit of the law.

If a court were to look at the spirit of the law there is evidence that the Legislature wanted to protect winners from signing away a major chunk of their winnings to third parties in exchange for a small amount. The Lottery's current affidavit transferring ticket ownership would appear to circumvent that intent. Technically, a person could transfer the winning ticket to a third party in exchange for a much smaller lump sum. The Lottery might argue that this is no longer an issue because the Lottery now offers the option of taking a lump sum. If so, then the Legislature should revisit whether it still needs the anti-assignment clause or should change the clause if one of the main reasons why the Legislature enacted it may no longer be an issue.

D. A Reason for the Legislature to Consider Revisiting the Anti-Assignment Clause – A Potential Conflict with the Uniform Commercial Code (UCC).

In 1998, the Board for the UCC substantially revised Article 9 of the code (secured transactions) and submitted those revisions for adoption to the states, including Minnesota.³⁴ Minnesota largely adopted the revisions, which took effect July 1, 2001.³⁵

Under the UCC, “accounts” are generally assignable.³⁶ The revised UCC expanded the definition of “accounts” to include “lottery winnings,” which would appear to conflict with Minnesota’s lottery prize anti-assignment statute.³⁷ The question is if the two statutes conflict, which controls? The UCC (and Minnesota’s adoption of it) is so complex that it is beyond our expertise to determine whether the revisions include language that would address the lottery

³² Minnesota Rules, 7857.6020(B), posted April 2, 1990.

³³ Massachusetts Annotated Laws 2016, chapter 10, sec. 28(4) (“Payment of any prize drawn may be made to a person under a voluntary assignment of the right to receive future prize payments, in whole or in part, if the assignment is made to a person or entity named as the assignee in an appropriate judicial order of a court of competent jurisdiction....”).

³⁴ Gene H. Hennig, “Changes in the Wind: Revised UCC Article 9,” *Bench and Bar* (September 2000). <http://www2.mnbar.org/benchandbar/2000/sep00/ucc-9.htm>.

³⁵ *Ibid.*

³⁶ Minnesota Statutes 2016, 336.9-406(f)(1). “[A] rule of law, statute, or regulation, that prohibits, restricts, or requires the consent of a government, governmental body or official, or account debtor to the assignment...of, or creation of a security interest in, an account...is ineffective.”

³⁷ Minnesota Statutes 2016, 336.9-102(a)(2)(viii). “‘Account’...means a right to payment of a monetary obligation, whether or not earned by performance...as winnings in a lottery or other game of chance operated or sponsored by a state, governmental unit of a state, or person licensed or authorized to operate the game by a state or government unit of a state.”

prize assignability issue.³⁸ We raise this because the question has spurred lawsuits in other states with differing results.³⁹

For example, in 2010, the Texas Supreme Court held that the UCC prevailed over the state lottery's anti-assignment statute.⁴⁰ The ruling stemmed from the case of Cletius Irvan who won a \$9 million Texas Lottery prize payable in 20 annual installments of just over \$440,000.⁴¹ Irvan assigned his last two payments to pay off a debt to the First State Bank of DeQueen but the Texas Lottery refused to allow the assignment based on the state's anti-assignment statute.⁴² The bank sued arguing that the UCC trumped the Lottery Act's prohibition.⁴³ The Texas Supreme Court agreed. It said the UCC provision was clear and unambiguous and that Irvan could assign his last two winnings.⁴⁴

In 2008, however, a California appellate court held that the state lottery's anti-assignment statute prevailed over the UCC provision.⁴⁵ In the case, Linda Foster tried to assign the final three jackpot prize payments to Stone Street Capital, which allows lottery winners to sell lottery prize payments for a lump sum payment.⁴⁶ As part of a divorce settlement, a court ordered the California State Lottery Commission to make the final payments to Stone Street Capital.⁴⁷ The Lottery Commission balked at the plan and appealed the court's decision.⁴⁸ The California Court of Appeals decided in favor of the Lottery. The appellate court said that when two seemingly inconsistent statutes conflict, the courts will hold that "a specific provision will take preference over a conflicting general provision."⁴⁹ In this case, the court said that the UCC broadly defines "account" to include at least eight categories, only one that describes lottery winnings in any state.⁵⁰ In contrast, the state's anti-assignment clause is more specific and therefore controls.⁵¹

³⁸ The UCC includes sec. 9-406(j), which allows states to say whether the UCC section prevails over specified inconsistent law. "This section prevails over any inconsistent provisions of the following statutes, rules, and regulations containing provisions inconsistent with this section...." Minnesota's Commercial Code, however, does not include 9-406(j) but substitutes a lengthy article on conforming changes. See *Laws of Minnesota 2000*, chapter 399, and *Laws of Minnesota 2001*, chapter 195.

³⁹ Although not binding on Minnesota courts, we provide examples to illustrate that the question has arisen in other states' courts.

⁴⁰ *Texas Lottery Commission v. First State Bank of Dequeen*, 325 S.W.3d 628, 639 (Tex. 2010).

⁴¹ *Ibid.*, at 632.

⁴² *Ibid.*

⁴³ *Ibid.*, at 633.

⁴⁴ *Ibid.*, at 639. Effective in 2013, the Texas Legislature added an exception to the Code for state lottery installment payments. *Texas Business and Commercial Code 2011*, sec. 9.406(k).

⁴⁵ *Stone Street Capital, LLC v. California State Lottery Commission*, 80 Cal. Rptr. 3d 326 (Cal. App. 2008).

⁴⁶ See <http://www.stonestreet.com/lottery.html>.

⁴⁷ *Stone Street Capital*, 80 Cal. Rptr. 3d at 329.

⁴⁸ *Ibid.*, at 330.

⁴⁹ *Ibid.*, at 333.

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

CONCLUSION

There does not appear to be a clear-cut answer. A court could narrowly read the anti-assignment clause as applying to prizes only; the text of the statute does say “prize” only. On the other hand, a court could view the Lottery’s affidavit form as circumventing the spirit of the law. It does not make any logical sense as to why the Legislature would intend to bar assignments of prizes but not the right to the prize in the form of the winning ticket.

Nonetheless, the Legislature should consider clarifying and updating the lottery prize statute. Because it is unclear why the Legislature enacted the anti-assignment clause, it should discuss the issue now and determine (1) whether the Lottery’s affidavit circumvents the Legislature’s intent behind the clause, (2) whether the clause is even necessary given changes that have occurred since its enactment in 1989, and (3) whether the clause conflicts with Minnesota’s Uniform Commercial Code.

ANALYSIS – QUESTION II

Does the Lottery’s practice of offering certain “Second Chance” prizes violate *Minnesota Statutes 2016, 349A.08, subd. 5*, if the Lottery (1) gives Second Chance winners less than “within a year” to collect their prizes, and (2) awards a prize to a second winner if the first forfeits?

BACKGROUND

The Lottery gives players a second bite at the prize apple under what it calls “Second Chance” promotions. Several times per year, the Lottery allows players who purchase a lottery ticket – winning or otherwise – to enter a subsequent drawing for prizes. For example, players have entered their non-winning ticket numbers for the chance to win trips, sporting goods, and cash.

Minnesota law says lottery winners have up to one year to claim their prizes.⁵² If a winner does not claim a prize within one year, the Lottery considers the prize “unclaimed.”⁵³ At the end of the fiscal year, the lottery director must transfer all unclaimed prize money to the state’s General Fund.⁵⁴

The prior Second Chance promotions, however, gave winners just ten days to claim their prizes or forfeit compared to the one-year claim period for lottery tickets. For example, a trip to Puerto Rico in the “Gopher Puerto Rico” game gave the winner ten days to collect or forfeit the prize. If a winner does not come forward within that ten-day window, the Lottery may award the prize to another player.

⁵² *Minnesota Statutes 2016, 349A.08, subd. 5*. For prize drawings, “within one year” begins to run on the date of the drawing at which the Lottery awarded the prize. If the Lottery awards a prize by a means other than a drawing, the claim period begins to run on the last day sales were authorized for a game. *Minnesota Rules*, 7857.5010, also gives players up to one year to claim the prize.

⁵³ *Ibid.*

⁵⁴ *Ibid.*

The Second Chance games raise questions about whether the Lottery is violating the unclaimed prize statute by:

1. Giving Second Chance winners less than a year to collect their prizes, and
2. Awarding a prize to a second winner if the original winner forfeits.

The Lottery maintains that Second Chance promotions fall into a gray area. Nonetheless, in July 2016, the Lottery adopted official rules for all of its Second Chance promotions, which give winners up to one year from the drawing date to claim their prizes and requires unclaimed prizes to go into the unclaimed prize fund.⁵⁵

DISCUSSION

A. Arguments for the Lottery's Position

The Lottery argues that the Second Chance promotions fall into a “gray area between a traditional lottery game and a sweepstakes” and therefore it is unclear whether it is violating the two statutes at issue. The Lottery notes that a lottery requires an offer, acceptance, and consideration (bargained-for exchange). On the other hand, there is no consideration in a sweepstakes because a person enters the drawing without paying. Lottery officials said that once the scratch ticket or lotto drawing occurs, “the wager (prize, chance, consideration) is complete....” The Lottery also contends that entering “a Second Chance promotion is optional, decoupling it from the original ticket purchase wager.”

In addition, the promotions are separate from a lottery ticket because Second Chance promotions:

- Are often but not always funded by marketing or promotional dollars not the consideration paid to purchase the ticket in a traditional lottery;
- Have different drawings;
- Have different odds; and
- Have their own rules, which bind players.

The Lottery also cited a Minnesota Rule for supporting its position, which says:

Independently of, or concurrently with, the operation of the lottery, the director may establish special drawings, bonuses, or additional prizes. The nature and number of prizes will be determined by the director. The drawing for promotional prizes may be held independently of the regular prize drawings or may be incorporated with those drawings.⁵⁶

Although the Lottery did not say so explicitly, its argument implies that the Second Chance promotions do not violate the unclaimed prize statute because they do not qualify as lottery

⁵⁵ Benjamin Freedland, General Counsel, Minnesota Lottery, memorandum to Executive Team, *Lottery Prize Policy Changes*, June 21, 2016.

⁵⁶ *Minnesota Rules*, 7857.7000, posted April 2, 1990.

prizes. (They do not require consideration.) The two experiences are separate, it argues, and once a person ends the first game so does the consideration. In addition, the above regulation gives the director discretion to set different rules for the Second Chance games.

B. Arguments Against the Lottery's Position

The Lottery's argument that the Second Chance promotions fall into a gray area between a traditional lottery game and a sweepstakes is simply not true. There is no continuum. Either it qualifies as a lottery or it does not. Regardless if the Second Chance games have different rules—odds, for example—the key question is whether a person must pay for a chance to win; is consideration required or not?

The Lottery argues that the initial lottery ticket and the promotions are two separate games. Once the lottery ticket wins or loses, the game is over and the promotion is another option to play, decoupling it from the original ticket or scratch off game. We could find no statutory or case law supporting this idea. We did find, however, at least one case that appeared to support the opposite. In *Minnesota Souvenir Milkcaps, LLC v. State of Minnesota*, the court said an in-package chance promotion is not a lottery if...one can participate for “free and without purchase of the package....”⁵⁷

If a person could enter the Second Chance promotions without paying for the original ticket, that would be a different situation. That is not the case here. In order to enter the Second Chance promotion, a person must first buy a lottery ticket.

CONCLUSION

The Second Chance promotion differences—for example, odds, funding, and rules—do not change the fundamental fact: Second Chance promotions require payment to play (consideration). As a result, the Second Chance promotions are part of the original purchase of the lottery ticket and, therefore, fall under the unclaimed prize statute.

AWARDING LOTTERY PRIZES TO PEOPLE UNDER AGE 18

Finally, during our audit, we noticed an apparent conflict between laws governing whether the Lottery may award prizes to persons under age 18.

Minnesota Statutes 2016, 349A.12, subd. 1, says, “A person under the age of 18 years may not buy or redeem for a prize a ticket in the state lottery.” *Minnesota Statutes 2016*, 349A.12, subd. 5, also bars an adult from giving a lottery ticket to a minor as a gift: “Nothing in this

⁵⁷ *Minnesota Souvenir Milkcaps, LLC v. State of Minnesota*, 687 N.W.2d 400 (Minn. Ct. App. 2004), review denied (Minn. Dec. 22, 2004) (The court said that an in-package chance promotion is not a lottery if...one can participate for “free and without purchase of the package....”). An in-package promotion is slightly different from the Lottery’s Second Chance promotions because an in-package promotion is included in the purchase of a “legitimate valuable product.” Second Chance promotions may have smaller pools than the original lottery ticket pool because players may decide not to enter their losing numbers for the second chance at a prize. An in-package promotion typically has one pool of players.

chapter prohibits giving a state lottery ticket as a gift, *provided that a state lottery ticket may not be given to a person under the age of 18* (emphasis added).⁵⁸

Nevertheless, *Minnesota Statutes 2016*, 349A.08, subd. 3, sets out a process for paying lottery prizes to persons under age 18:

1. If the prize is less than \$5,000, the director may give a draft, payable to the order of the person under age 18, to the person's parents, custodial parent if one parent has custody, guardian, or other adult member of the person's family; and
2. If the prize is \$5,000 or more, the director shall deposit the prize with the district court and section 540.08 applies to the investment and distribution of the money.

The Lottery's Counsel agrees the statutes appear to contradict and has consequently interpreted the contradiction to prohibit paying prizes to persons under age 18. The Lottery said that according to senior Lottery staff members who have been with the Lottery since its inception, the Lottery has not knowingly paid a prize to a person under 18 in over 20 years.⁵⁹

Again, we recommend that the Legislature clarify the law involved with this issue.

⁵⁸ *Minnesota Statutes 2016*, 349A.12, subd. 5.

⁵⁹ Benjamin Freedland, General Counsel, Minnesota Lottery, memorandum to Laura A. Wilson, Audit Coordinator, Office of the Legislative Auditor, April 15, 2016, *Email Questions*, May 13, 2016.

OLA Exhibit 1

MINNESOTA STATE LOTTERY Affidavit of Ticket Ownership

STATE OF MINNESOTA)
)ss.
County of _____)

residing at _____

(Affiant's Name)

(Present Address)

County of _____

being first duly sworn, hereby deposes and says that the following is just, true and correct:

1. The attached copy of the _____ ticket (game, pack and
(Game Name of Ticket)
ticket number _____) was originally signed by myself.
2. I turned the ticket over to _____ to claim the prize at the
(Name of new claimant / owner)
Minnesota State Lottery and have given permission to _____
(Name of new claimant / owner)
to cross my name off the ticket.
3. I relinquish any and all rights that I may have had in said ticket and agree that the
Minnesota State Lottery is relieved from any liability owed to me from any prize due
to me from said ticket.

Signature of Affiant*

Subscribed and sworn to me before this

____ day of _____, 20 ____.

Notary Public

My commission expires _____

* You must sign this affidavit before a Notary Public or a Lottery Validation Clerk

Office Use Only – To be completed by Validation Clerk
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Reason for Affidavit:

Headquarter Approval Given by:

Validation Clerk's Signature

Appendix B. Status of Prior Findings

Table 3 shows the status of the prior findings included in the Office of the Legislative Auditor, Financial Audit Division Report 13-12, *Minnesota State Lottery Internal Controls and Compliance Audit*, issued June 20, 2013. We determined the status of these prior findings based on the work done for this report.

Table 3
Minnesota State Lottery
Internal Controls and Compliance Audit
Status of Prior Findings as of July 2016

Prior Finding Number	Prior Finding	Follow up Procedures	Status
1	The Minnesota State Lottery was unable to resolve an \$85,000 difference between the recorded cash balance in its accounting system ledger and the recorded cash balance in the state's accounting system.	We verified the cash balances in the two accounting systems agreed as of July 2016.	Resolved
2	The Minnesota State Lottery did not remove limited bank file access for two former employees.	We reviewed the March 2016 bank file access reports and found only current employees on the list.	Resolved
3	The Minnesota State Lottery did not review some key payroll reports, and two employees could authorize their own timesheets.	We reviewed a sample of pay periods and found the Lottery's payroll staff consistently reviewed the key reports. We also reviewed the report showing the timesheet approval hierarchy, and saw no one could approve their own timesheet.	Resolved
4	The Minnesota State Lottery did not report nonmonetary prize winners to the Department of Revenue to determine whether they were delinquent in payment of state taxes or owed other public debts.	We reviewed the Lottery's January 2014 Debt Set-Off procedures showing the Lottery requires winners of nonmonetary prizes to pay delinquent state taxes or other public debt before receiving any prize.	Resolved
5	The Minnesota State Lottery allowed three employees to accumulate frequent flier miles on personal accounts without ensuring rewarded miles were used to reduce cost of future state-paid business trips.	We reviewed the Lottery's frequent flier tracking sheet as of May 2016 and found them up to date.	Resolved

Source: Office of the Legislative Auditor



October 31, 2016

James R. Nobles, Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, Minnesota 55155

Re: Office of the Legislative Auditor – Lottery Audit Response

Dear Mr. Nobles:

Thank you for your recent audit of the Minnesota Lottery for the period of January 2014 through February 2016. The Lottery believes in the importance of independent audits and welcomes your team's review of our operations.

The Lottery belongs to Minnesota, and our mission is to serve its citizenry by providing fair, fun, and secure games that help fund our important beneficiaries. We were encouraged to find that the audit report finds little to criticize in the day-to-day operations of the Lottery, or any evidence of systematic problems with the Lottery's contracting, accounting, or management. Most importantly, there are no findings regarding the security and integrity of the Lottery's games.

The audit report contains nine findings. For each finding, most of the recommendations have already been implemented. The remaining recommendations will be implemented in the near future. Further, the Lottery has recently hired a Chief Information Security Officer, a new executive-level position tasked with protecting the Lottery information and systems, and continuously improving its internal processes and controls.

Additionally, the report identifies legal questions about two longstanding Lottery practices. The Lottery appreciates the analysis of these issues. Current Lottery leadership has stressed that all Lottery policies and practices must be fully compliant with a conservative reading of Minnesota law. Consequently, effective July 1, 2016, the Lottery ended both practices discussed in the audit.

The Lottery recently completed its best fiscal year ever. In Fiscal Year 2016, the Lottery paid \$365.9 million in prizes, \$35.6 million in retailer commissions, and most importantly, returned \$144.7 million dollars to its environmental and government beneficiaries. The Lottery will build on this success by using the audit report to improve its internal controls, compliance, and technology systems.

Thank you again for your team's efforts and the opportunity to comment on the audit report.

Sincerely,

Michael Vekich
Acting Executive Director

Finding 1	The Minnesota State Lottery did not have sufficient formal, documented policies and procedures for all information technology control areas.
Response	<p>The Minnesota Lottery agrees on the importance of sufficiently documented policies and procedures for all information technology control areas. While the required activities are occurring, the Lottery acknowledges the need for improved documentation. The Lottery has begun policy initiatives that will address the lack of documentation by enhancing existing policies and procedures and writing new policies and procedures to fill gaps where written documentation is lacking. As of the date of this letter, the Lottery has adopted new and improved policies regarding:</p> <ul style="list-style-type: none"> • Periodically reviewing users' access to information systems to ensure that access is appropriate for the users' job functions, and • Making changes to systems to ensure that employees only make authorized changes. <p>Additionally, the Lottery will adopt and/or improve its policies regarding:</p> <ul style="list-style-type: none"> • Monitoring and auditing user activity on the Lottery's information system network, • Administering changes to the Lottery's firewall settings, • Assessing information technology risks to the Lottery's mission, functions, and reputation, and • Managing and monitoring of software on Lottery computers to reduce the risk that employees change the standard structure of its systems.
Responsible	Wes Harms, Director of Operations
Resolution	On or before December 31, 2016
Finding 2	The Minnesota State Lottery did not always have sufficient evidence of the review and approval of changes made to its computer systems.
Response	<p>The Lottery agrees that there were cases where changes were not properly documented and that better standards and procedures are needed. The Lottery has implemented new policies, standards, and procedures to ensure that appropriate controls are documented and that all changes complete a formal, documented review process.</p>
Responsible	Wes Harms, Director of Operations
Resolution	Complete

Finding 3	The Minnesota State Lottery did not have an adequate plan to recover its information technology operations in the event of a disaster.
Response	The Lottery agrees on the importance of an adequate disaster recovery plan. The Lottery has a plan and budget to create a hot backup capability for its accounting system. Additionally, the Lottery recognizes that substantial improvements to its existing disaster recovery plan are necessary. The Lottery will revise the current plan as an agency-wide initiative. This will involve updating its risk analysis by department, creating an improved business continuity plan, and drafting an agency-wide coordinated disaster recovery plan.
Responsible	Doug Wills, Director of Security
Resolution	Risk assessment on or before January 31, 2017; business continuity plan on or before February 28, 2017; and coordinated disaster recovery plan on or before March 31, 2017
Responsible	Wes Harms, Director of Operations
Resolution	Hot backup capability for its accounting system on or before July 1, 2017
<hr/>	<hr/>
Finding 4	The Minnesota State Lottery did not periodically ensure it appropriately limited people's access to its information systems and physical facilities.
Response	The Lottery agrees. For its information systems, the Lottery has completed a complete review of access and has implemented a new identity and access management policy, standard, and procedure requiring quarterly reviews of all user accounts. For physical facilities, the Lottery has begun a daily review of the card key access events for the two doors in to its primary data center.
Responsible	Wes Harms, Director of Operations Doug Wills, Director of Security
Resolution	Complete
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Finding 5	The Minnesota Lottery's information systems did not require complex passwords for users to log onto the Lottery's systems.
Response	The Lottery agrees and has implemented a new identity and access management policy, standard, and procedure. The new policy mandates strong passwords for all lottery managed systems.
Responsible	Wes Harms, Director of Operations
Resolution	Complete

Finding 6	The Minnesota Lottery did not document a formal, organization-wide plan to respond to security incidents.
Response	The Minnesota Lottery agrees on the importance of a formal, organization-wide security incident response plan. While the required activities are occurring, the Lottery acknowledges the need for improved organization-wide documentation. The Lottery has begun policy initiatives that will address the lack of documentation by enhancing existing policies and procedures and writing new policies and procedures to fill gaps where written documentation is lacking.
Responsible	Doug Wills, Director of Security
Resolution	On or before December 31, 2016
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Finding 7	The Minnesota State Lottery did not adequately limit employee access to retailers' not public information.
Response	The Lottery has made a programming change to its system that restricts access to this information to a specific group of employees who require the information. Additionally, the Lottery completed a complete review of user access to verify each user has only the access level needed to perform their job functions and adopted a new identity and access management policy requiring quarterly reviews. Finally, the Lottery has installed new locks on file cabinets containing nonpublic retailer information. Staff with a business need to access retailer information has been instructed to monitor and lock these file cabinets when not in use.
Responsible	Doug Wills, Director of Security Benjamin Freedland, General Counsel
Resolution	Complete
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Finding 8	The Minnesota Lottery did not fingerprint and conduct all required background checks for its temporary employees.
Response	While state level criminal background checks have always been conducted on all employees, including all temporary employees, the Lottery agrees with this finding. As of July 1, 2016, all temporary employees are now fingerprinted regardless of duration of time employed.
Responsible	Doug Wills, Director of Security
Resolution	Complete

Finding 9 The Minnesota State Lottery did not verify whether retailer owners and partners were Lottery employees or family members living in the employees' households.

Response The Lottery agrees and has directed staff to check retailer applications against the Lottery employee database. Results of this search are attached and made part of retailer applications and renewals. Policies, standards, and procedures will be drafted and incorporated into the overall security policies.

Responsible Doug Wills, Director of Security

Resolution On or before December 1, 2016
