Assembly Banking and Finance Committee

Informational Hearing

Banking the Medical Cannabis Industry

February 29, 2016

2:00 p.m.

State Capitol, Room 4202

Banking Medical Cannabis Businesses (MCBs)

On January 1, 2016, the regulation and oversight of medical marijuana came under the control and guidance of The Medical Marijuana Regulation and Safety Act (MMRSA). MMRSA was the result of a three bill package, AB 243 (Wood), AB 266 (Bonta) and SB 643 (McGuire). These bills govern cultivating, processing, transporting, testing, and distributing medical cannabis to qualified patients. As the discussion around medical marijuana continues in the Legislature the difficulty of "banking" MCBs has become part of the larger dialogue. Medical Marijuana is estimated to be a $2.7 billion industry in California. The lack of banking services creates public safety issues, difficulties in paying employees and only further feeds into stereotypes as participants in the industry must trade envelopes of cash for basic services. It creates revenue and taxation issues for local governments and the state of California as MCBs are unable to make electronic payments for taxes or licensing fees, and instead must transport envelopes or even bags full of cash to the offices of the State Board of Equalization to pay state sales taxes. Some individuals and businesses in this industry are forced to use creative business structures in order to pay fees, taxes, make payroll, and collect payments that could lead to even further risks as they blur the line of what is a legal business formation.

The future regulation of MCBs and access to financial institutions are a vital part of a larger discussion about the conflict between California, which has legal medical marijuana and federal law which classifies marijuana as a controlled substance. Achieving mainstream banking for MCBs is not as straightforward as proposing changes to state law.

Summary of Obstacles

Lack of access to Federal Reserve System (FRS): A financial institution must have access to the FRS to deposit funds and transfer funds electronically. This account is known as a master account and is effectively the bank's bank account. Attempts thus far to establish state chartered financial institutions for MCBs have been unsuccessful due to those institutions not being able to access the FRS.

Deposit insurance: Federally or state chartered financial institutions are required to have deposit insurance. Credit unions may get insurance through the National Credit Union Administration (NCUA) or private insurance. Neither NCUA or private insurers have been willing to insure the nation's first cannabis based credit union in Colorado.

Compliance costs issues: Banking MCBs can create additional compliance costs for institutions as they perform reviews and oversight to comply with the Federal rules and regulations

concerning money laundering controls. Financial institutions have also reported the potential need for increased security in branches as large amounts of cash would be deposited.

Racketeer Influenced and Corrupt Organizations (RICO) Act: Activities that could benefit a criminal enterprise would fall under the RICO Act and place financial institutions in danger of violation. A violation could risk forfeiture of an institution's assets or collateral used to secure loans.

Cole memo: On August 29, 2013, James M. Cole, the Deputy Attorney General issued what is now known as the "Cole memo." The Cole memo attempts to clarify how the Department of Justice (DOJ) would use its resources to enforce the Controlled Substances Act (CSA) in states with legalized medical or recreational cannabis. The memo specifies several things that the DOJ would look at in making a determination to enforce the CSA. The Cole memo did not add clarity to the issue of banking MCBs.

Financial Crimes Enforcement Network (FinCEN) Guidance: FinCEN issued guidance in 2014 clarifying the Bank Secrecy Act expectations for MCBs. This guidance requires financial institutions to conduct enhanced due diligence when opening an account for a MCB including a specific filing requirement for suspicious activity reports (SAR) that included new SARs known as Marijuana Limited SAR, Marijuana Priority SAR and Marijuana Termination SAR. This due diligence was also required to be conducted on an ongoing basis and includes the monitoring of public information.

Discussion

An obstacle faced by those operating MCBs in California is the lack of banking services. Businesses ranging from dispensaries to growers all operating within California's legal framework have faced the closure of bank accounts or denial of new accounts. This has led to fees and taxes being paid at government offices with large bags of cash that only raise further suspicion or create security concerns.

On February 14, 2014 the FinCEN issued guidance (FIC-2014-G001) to clarify Bank Secrecy Act compliance expectations for financial institutions seeking to provide services to cannabis-related businesses. Financial institutions and those in the legal cannabis business hoped that the guidance would provide greater clarity and potentially open up more financial institutions for access. Unfortunately, the guidance only added further confusion and did little to eliminate the risk faced by financial institutions.

Banks are required to file SARs when they think that a transaction might have an illegal connection such as drug trafficking. Rather than clarify the existing SAR process for legal

cannabis businesses the new guidance outlines three tiers of SARs to use just for cannabis businesses: “cannabis limited,” “cannabis priority,” and “cannabis termination.” In spite of expanding paperwork requirements FinCEN was quoted in the press as saying that these changes would reduce the burden on banks. Almost two years after the issuance of this guidance, financial institutions are still hesitant to open accounts for legal cannabis businesses whether they are in California or other states that have legal medical or recreational cannabis.

The current federal enforcement policy concerning state legalized cannibals activity is contained in a document discussed previously as the Cole memo. This memo provides guidance to federal enforcement authorities giving the status of cannabis as legal for medical or recreational use in several states. The Cole memo illuminates how federal prosecutorial resources will be focused on the issue of cannabis by providing the following enforcement priorities:

1) Preventing the distribution of cannabis to minors;

2) Preventing revenue from the sale of cannabis from going to criminal enterprises, gangs, and cartels;

3) Preventing the diversion of cannabis from states where it is legal under state law in some form to other states;

4) Preventing state-authorized cannabis activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;

5) Preventing violence and the use of firearms in the cultivation and distribution of cannabis;

6) Preventing drugged driving and the exacerbation of other adverse public health consequences associated with cannabis use;

7) Preventing the growing of cannabis on public lands and the attendant public safety and environmental dangers posed by cannabis production on public lands; and

8) Preventing cannabis possession or use on federal property.

This list of priorities would seem to blunt any arguments that the federal government is looking to override the state laws that allow some use of cannabis. Yet the Cole memo also includes the following language left open to broad interpretations.

> *If state enforcement efforts are not sufficiently robust to protect against the harms set forth above, the federal government may seek to challenge the regulatory structure itself in*

addition to continuing to bring individual enforcement actions, including criminal prosecutions, focused on those harms.

The FinCEN guidance and the Cole memo do not provide a safe harbor to financial institutions, but rather outline a series of actions that ultimately are not a guarantee that an institution could face sanction. Furthermore, financial institutions face the uncertainty that should federal enforcement of drug laws increase, even with state level marijuana legalization, that they run the risk of having assets seized or frozen, particularly assets that have been used as collateral for loans and lines of credit with financial institutions. Without a change to the status of cannabis as a Schedule I drug at the federal level, businesses legal under state law will continue to operate in a murky area where enforcement of federal law is only as consistent as federal policy, versus statute, wants it to be.

Test case

Denver-based Fourth Corner Credit Union was established to serve the financial needs of the cannabis and hemp industries. Fourth Corner was provided a credit union charter by the Colorado Division of Financial Services in April of 2014 but was subsequently denied deposit insurance by the National Credit Union Administration. Additionally, they were denied a master account at the Federal Reserve Bank of Kansas City. A master account is effectively a bank's bank account. Master accounts at Fed branches allow banks to not only deposit their cash reserves, but gives banks the ability to easily transact business with other financial institutions by settling credits and debits through the account at that Fed branch bank. A financial institution without a master account would be prevented from conducting most types of electronic funds transfers. Fourth Corner filed legal action against the Federal Reserve Bank of Kansas City*, Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City (D. Colo., 15-cv-01633).* In January of 2016 the case was dismissed leaving the hope for mainstream banking services up in smoke.

The opinion dismissing the *Fourth Corner* case outlines the major obstacles to providing banking services to state legalized cannabis businesses. The Court found,

> *"…because any affirmative legal action that Colorado takes to facilitate the distribution of marijuana is preempted by federal law." and;*
>
> *…"The Cole Memorandum" and the "FinCEN guidance" discussed at some length in the compliant do not change that analysis. And;*
>
> *"In light of the CSA, Colorado lacks the power to grant a credit union charter with the knowledge that the credit union is designed to aid and abet violations of federal law by*

offering banking services to businesses engaged in the manufacture and/or distribution of marijuana."

Finally, Judge Jackson calls into question the effectiveness of the Cole Memo and FinCEN guidance and that this issue needs to be addressed by Congress:

> *Plaintiff contends that the FinCEN guidance and Cole memorandum already provide federal authorization to financial institutions to serve MRBs. Therefore, offering to serve MRBs only if authorized by federal law is something of a sleight of hand. The problem is, the FinCEN guidance and Cole memorandum do nothing of the sort. On the contrary, the Cole memorandum emphatically reiterates that the manufacture and distribution of marijuana violates the Controlled Substances Act, and that the DOJ is committed to enforcement of that Act. It directs federal prosecutors to apply certain priorities in making enforcement decisions, but it does not change the law. The FinCEN guidance acknowledges that financial transactions involving MRBs generally involve funds derived from illegal activity, and that banks must report such transactions as "suspicious activity." It then, hypocritically in my view, simplifies the reporting requirements. In short, these guidance documents simply suggest that prosecutors and bank regulators might "look the other way" if financial institutions don't mind violating the law. A federal court cannot look the other way. I regard the situation as untenable and hope that it will soon be addressed and resolved by Congress.*

An initial analysis of the decision makes it clear that the creation of a state licensed bank or credit union created for the purpose of servicing MCBs is not a legally viable option until federal law is changed.

State Bank

Periodically, the concept of creating a state run and operated financial institution has been considered as a fix for a host of issues. Recently, the state bank idea has been floated as a potential solution to provide business banking services to MCBs. A state operated financial institution generates several questions and concerns even before considering its uses for MCBs. What assets would provide the appropriate capitalization for a state bank? Would such an entity create pressures on the General Fund in the event of losses or failure of the bank? Who would be in charge of day-to-day operations? What would be the initial costs to the state to set up such a bank and pay for staff? These are only a few of the questions that generally concern the creation of a state bank. Creating a state bank to service MCBs or making the service of MCBs one part of the operation of a state bank does not eliminate the existing hurdles faced by

regular financial institutions. The state bank would still need access to the Federal Reserve System and deposit insurance which the *Fourth Corner* makes clear is not legally possible.

Alternatives to Traditional Banking Relationships

The difficulties of banking MSBs has become magnified as many other states have legalized marijuana either by expanding medical marijuana usage or the full scale legalization such as in Colorado. In response to this growth several companies have created banking alternatives designed to provide electronic transactions for MCBs and assist with FinCEN and *Cole Memo* requirements. These alternatives range from kiosk type interface systems that allow customer payment and order without exchanging cash at the MCB to mobile phone applications that service as a digital wallet to allow customers to pay with their phone from an account that is preloaded with funds. Many of these systems also include inventory management, product tracking and customer transaction tracking in an attempt to comply with the requirements under federal anti-money laundering laws. A recent article (February 16, 2016) in The New York Times, *As Marijuana Sales Grow, Start-Ups Step In for Wary Banks* stated:

> *Most of the start-ups trying to help with this problem are focuses in one way or another, on tracking every detail of every purchase in a more sophisticated way. Careful record-keeping can answer the concerns of banks worried about violating anti-money laundering laws.*

Careful record keeping can assuage concerns about anti-money laundering violations, but it would be overly simplistic to state that financial institutions are concerned only with this one aspect given the various concerns already outlined in this document.

Current Federal Action

Congressman Perlmutter (D-Colorado) has introduced H.R. 2076 - Marijuana Businesses Access to Banking Act of 2015. H.R. 2076 would provide a safe harbor for depository institutions that provide products or services to legal cannabis businesses and prohibits a federal banking regulators from: (1) terminating or limiting the deposit or share insurance of a depository institution solely because it provides financial services to a cannabis-related legitimate business; or (2) prohibiting, penalizing, or otherwise discouraging a depository institution from offering such services.

Conclusion

Marijuana's inclusion under the CSA leaves states with legalized marijuana, whether for medical or recreational use, in a difficult position where any potential safe harbor is only as good so long as federal enforcement of the CSA ignores states with legalization. However, financial

institutions face this problem even more directly due to their regulatory nexus with the federal government via the need for deposit insurance and access to the Federal Reserve. These are not the only considerations, as previously banking regulators have urged banks to avoid reputational risk involved with banking certain "high risk" although legal industries.

The current difficulties will only increases exponentially. The implementation of MMRSA will expand the volume of business and state licensing fees will need to be paid in addition to taxes and potential local fees. The payment of licensing fees and taxes will remain problematic until the banking question is answered. MMRSA requires an initial and yearly licensing fee which is likely to be paid in cash unless a solution is reached. Media reports suggested that cities and counties throughout the state are considering additional marijuana fees and taxes, yet these jurisdictions will have to deal with large amounts of cash to cover these payments. These are obstacles for the current legal medical marijuana industry. If the medical cannabis banking situation that exists today were to continue in event of full state legalization of recreational use of marijuana the potential volume and scale of transactions could freeze the industry as BOE and other agencies and local governments would be unable to process the cash associated with such volume.

Establishing alternatives to bank accounts may provide short-term workarounds to the current difficulties of banking MCBs such as removing large amounts of cash from the system. However, the essential deciding factor that will open up access to banking would be either a change of the CSA to remove marijuana from the list of controlled substances or the creation of a safe harbor for financial institutions that offer accounts to state legalized MCBs.