

Date of Hearing: June 18, 2018

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Monique Limón, Chair

SB 930 (Hertzberg) – As Amended May 25, 2018

**SENATE VOTE:** 32-6

**SUBJECT:** Financial institutions: cannabis

**SUMMARY:** Provides for the licensure and supervision of cannabis limited charter banks and credit unions authorized to offer limited depository services to cannabis businesses. Restricts the activities of cannabis limited charter banks and credit unions to accepting deposits and issuing and redeeming special purpose checks. Prohibits a cannabis limited charter bank or credit union from engaging in banking activity with any other financial institution that lacks a limited purpose charter.

Specifically, **this bill:**

1. Adds a new division within the Financial Institutions Law (Financial Code Section 99 et seq.) called the Cannabis Limited Charter Banking and Credit Union Law (Financial Code Section 11000 et seq.).
2. Defines “banking services” as the provision of depository services with respect to cash or other funds and the issuance and acceptance of special purpose checks, including the acceptance and maintenance of deposit proceeds, as specified.
3. Defines “cannabis business” as a person licensed by the state of California to engage in commercial cannabis activity under Division 10 of the Business and Professions Code and an ancillary business that serves such a licensed person.
4. Provides for the licensure of a cannabis limited charter bank or credit union (hereafter referred to as a “cannabis depository institution” or “CDI”) by the Department of Business Oversight (DBO) and requires such licensees to comply with all requirements of the Financial Institutions Law, as applicable, except to the extent that any requirement of that law is inconsistent with the provisions of this bill, in which case the provisions of this bill would prevail.
5. Requires a CDI to adopt policies and practices that allow it to achieve the principles and goals outlined in the federal Bank Secrecy Act and cooperate with the federal Financial Crimes Enforcement Network.
6. Authorizes a CDI to accept deposits and issue to an account holder special purpose checks that may only be used to:
  - a. Pay fees or taxes to the state or a local jurisdiction.
  - b. Pay rent on property that is leased by, or on behalf of, the account holder’s cannabis business.

- c. Pay a vendor physically located in California for expenses related to the account holder's cannabis business.
  - d. Purchase bonds or similar debt instruments issued by the state or a local agency.
7. Authorizes the state and local agencies to accept special purpose checks.
  8. Specifies that no private or public entity is required to accept special purpose checks.
  9. Authorizes a CDI to cash a special purpose check presented by a person that is not an account holder if the check was used for an authorized purpose, as specified in #6 above.
  10. Requires a CDI to obtain and maintain private insurance for itself and its assets, in an amount acceptable to DBO.
  11. Authorizes a CDI to form a banking network with other CDIs to assist each other in providing services to cannabis businesses, subject to the approval of DBO. Prohibits this network from including any institution that is not a CDI.
  12. Authorizes a CDI to charge fees for the banking services it provides and requires the CDI to provide a fee schedule to DBO that must be posted on the department's website.
  13. Prohibits a CDI from engaging in banking activity (this bill does not define this term) with any financial institution that lacks a limited charter.
  14. Prohibits a CDI from engaging in any activity beyond those necessary to accept deposits and perform actions expressly authorized by this bill.
  15. Creates the Cannabis Limited Charter Bank and Credit Union Advisory Board, comprised of the Treasurer, the Controller, and the Chief of the Bureau of Cannabis Control. Requires DBO to submit annual reports related to enforcement activities and requires the Board to evaluate the reports and make recommendations to the Legislature and Governor.
  16. Makes findings and declarations related to the history of cannabis legalization in California, federal policy related to cannabis, and the need for banking services in the cannabis industry.

**EXISTING STATE LAW:**

1. Provides for the licensure and regulation of commercial cannabis activities by various state agencies.
2. Authorizes DBO to license and regulate financial institutions, including banks and credit unions (Financial Code Section 99 et seq.).

**EXISTING FEDERAL LAW:**

1. Classifies cannabis as a Schedule 1 substance under the Controlled Substances Act (21 U.S. Code 812 et seq.) and places regulatory restrictions on research, supply, and access to Schedule 1 substances.

2. Requires financial institutions to report suspected illegal activity to the federal government (31 U.S. Code 5311 et seq.), including activity of suspected cannabis businesses that operate under state law.
3. Provides that all property purchased using proceeds from an illegal activity is subject to forfeiture (18 U.S. Code 1961 et seq.).

#### **FISCAL EFFECT:**

#### **COMMENTS:**

##### 1) PURPOSE

According to the author's office:

*The cannabis industry is expected to generate between \$8-20 billion annually. In the first two months of adult-use cannabis legalization, consumers bought an estimated \$339 million worth of marijuana products from retailers in California. From a business perspective, collecting large sums of cash payments is not practical.*

##### 2) BACKGROUND

Federal law prevents some cannabis businesses from accessing financial services provided by banks and credit unions, including basic checking accounts and electronic payment services that nearly all business rely to facilitate transactions with their customers. As briefly explained in the Existing Federal Law section above, federal law categorizes cannabis as a controlled substance and prohibits the possession and distribution thereof. Additionally, federal law<sup>1</sup> places requirements on financial institutions to deter money laundering through reporting of suspected illegal activity, which includes commercial activities related to cannabis. Federal law enforcement agencies, such as the Department of Justice, and federal regulators, including the Federal Reserve, National Credit Union Administration, and Federal Deposit Insurance Corp, have discretion in how these laws are implemented and enforced. Federal guidelines have provided comfort to several hundred banks and credit unions across the country to serve the cannabis industry; however, these financial institutions are doing so at their own risk of negative regulatory action and criminal prosecution.

Although some banks and credit unions accept the elevated legal risk and compliance costs to serve some cannabis businesses, many cannabis businesses in California do not have access to banking services. According to a survey conducted by the California Growers Association in 2017, more than two-thirds of its membership is unbanked, with cultivators having the lowest level of access along the supply chain. Unbanked cannabis businesses are forced to transact primarily in cash, which makes the businesses and surrounding community targets for violent criminal activity. Cash businesses also present challenges to state and local tax collection and enforcement efforts.

##### 3) THE VISION OF SB 930

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<sup>1</sup> The Bank Secrecy Act as amended by the USA Patriot Act (31 U.S. Code 5311 et seq.)

This bill envisions a partial solution to the cannabis banking problem through the creation of cannabis limited charter banks and credit unions (hereafter referred to as “cannabis depository institution” or “CDI”). Upon approval by the Department of Business Oversight (DBO) of a charter application, a CDI would be authorized to provide a very limited selection of services to its customers: the acceptance of deposits and the issuance and redemption of special purpose checks. These special purpose checks are limited to four general uses: 1) the payment of fees and taxes to local and state government agencies, 2) the payment of rent on property leased by, or on behalf of, a cannabis business, 3) payments to vendors physically located in California for expenses related to goods and services associated with the cannabis business, and 4) the purchase of bonds or similar debt instruments issued by the state or specified local agencies. CDIs are also authorized to form a network exclusively with other CDIs to assist each other in providing services to cannabis businesses.

Under this bill, CDIs are prohibited from engaging in most banking activities. This bill prohibits CDIs from offering common banking services, such as:

- merchant accounts that allow businesses to accept electronic payments (e.g., debit and credit cards);
- processing Automated Clearing House (ACH), Fedwire, or other electronic payment transactions that rely on networks that include any non-CDI financial institutions; and
- making, offering, brokering, or servicing loans.

In order to meet the needs of the cannabis industry, a substantial number of CDI branches will be necessary. Given the prohibitions against processing electronic payments and funds transfers, CDI branches must be in reasonable physical proximity to users of CDIs. Account holders will need access to a nearby branch in order to make regular cash deposits that significantly reduce the incentive for theft and robbery at their premises. Furthermore, CDI branches must be conveniently located and widely accessible to entice potential payees of special purpose checks to voluntarily agree to accept such checks.

#### 4) IMPLEMENTATION CHALLENGES

In order to achieve the vision of SB 930, the state government and the private sector would need to overcome significant challenges to deliver the public benefits that this bill seeks. This section outlines several of the most considerable challenges, but should not be viewed as an exhaustive list.

##### **Timing of Rulemaking and Application Process**

As detailed in the Senate Banking and Financial Institutions Committee’s analysis of SB 930, dated April 18, 2018, this bill lacks specificity regarding which sections of existing Financial Institutions Law (Financial Code Section 99 et seq.) would apply to CDIs. The bill provides that CDIs must comply with all requirements of the Financial Institutions Law, as applicable, except to the extent that those requirements are inconsistent with the requirements proposed by this bill. Rather than specify which requirements of existing law apply to CDIs, this bill would defer that responsibility to DBO and does not provide clear intent from the Legislature on how DBO should make those decisions.

Due to the lack of specificity in the bill, the rulemaking process conducted by DBO is likely to be lengthy. Despite the authority granted to DBO by this bill to adopt emergency regulations, the

rulemaking process will be cumbersome as the department examines each section of the Financial Institutions Law to determine its applicability to CDIs. Given the unique characteristics of the proposed CDI and the lack of any similar institution operating in the state or anywhere in the country, DBO will likely encounter sections of existing law that may be difficult to tailor to a CDI. DBO will also be required to clarify vague or undefined provisions in this bill, such as the prohibition of undefined “banking activities” between a CDI and a traditional financial institution. It is reasonable to assume that the rulemaking process could take a year or more based on prior rulemaking activities conducted by DBO, meaning DBO may not be able to accept CDI applications until the beginning of 2020.

Upon completion of rulemaking, DBO will be able to accept applications from persons interested in establishing a CDI. Under existing law, it takes nine months to get a bank or credit union charter, in the best case scenarios. In those best case scenarios, applicants have worked with experienced industry consultants to ensure that the application meets DBO’s requirements. Some of the factors that DBO considers when reviewing a charter application include:

- the character, reputation, and financial standing of the organizers or incorporators and their motives in seeking to organize the proposed bank,
- the character, financial responsibility, banking or trust experience, and business qualifications of the proposed officers of the bank,
- the character, financial responsibility, business experience, and standing of the proposed stockholders and directors,
- the adequacy of banking facilities to support its operations,
- the reasonableness to achieve and maintain profitability, and
- the viability of the Business Plan given the economic condition, growth potential, and competition of the proposed market area.

To the extent that an applicant has weaknesses in any of these factors, the application process will likely exceed nine months and the application could ultimately be denied. Due to the unique risks posed by a CDI, it is reasonable to assume that the initial application process could take longer than nine months. In a rather optimistic scenario, the first CDI could be approved by the beginning of 2021.

### **Private Insurance**

This bill requires CDIs to obtain and maintain private insurance in an amount acceptable to the Commissioner of DBO. Typically, deposits at traditional banks and credit unions are insured by federal agencies<sup>2</sup> with risk pooled across a wide breadth of financial institutions and ultimately backed by the federal government. Private deposit insurance is not widely available, and there appears to be only one provider in the country, American Share Insurance (ASI).

The insurance requirement in this bill may be difficult to comply with. As of the writing of this analysis, Assembly Banking Committee staff has not learned of any entity that is interested in insuring a CDI. Setting insurance premium rates is predicated on risk analysis informed by empirical evidence. In the case of CDIs, there are no historical data that can be used to estimate the risk of an insured loss. Furthermore, CDIs would primarily serve an industry that operates in direct violation of federal law, exposing a CDI to federal enforcement actions that could result in

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<sup>2</sup> The Federal Deposit Insurance Corp or the National Credit Union Administration

the seizure of all assets held by the CDI on behalf of cannabis businesses. The lack of historical data and the concentration of risk in an illegal industry pose significant barriers for a private insurer to engage in this line of business. If an insurer is willing to accept the risk, the premiums may be expensive, leading to larger fees for cannabis businesses.

### **Fee structures**

Unlike traditional banks that receive a significant portion of their income from net interest margins<sup>3</sup> and fees from large transactions, CDIs' revenue will solely rely on a very limited number of services to generate fee income from account holders. The fees charged by a CDI will need to be sufficient to recover the cost of operations, including significantly high cash handling expenses, relatively high insurance premiums and costs for complying with anti-money laundering policies and procedures.

### **Verifying a special purpose check was used for authorized purpose**

This bill authorizes a CDI to cash a special purpose check presented to it by a person that is not an account holder, if that CDI previously issued the check to an account holder and the check was used for one of the purposes authorized by this bill. The bill does not specify how a CDI should verify that the check was used for an authorized purpose. It is likely that DBO will need to provide further clarification through regulations of how licensees should comply with this requirement. These requirements may include the verification of lease agreements and verifying the licensing status and approved payees of cannabis businesses.

### **CDIs would not be immune to federal law enforcement actions**

As proposed by this bill, CDIs would not be insulated from federal law enforcement action. The operations of cannabis businesses violate federal law, and their assets can be seized by law enforcement agencies under the authority of the RICO Act (18 U.S. Code 1961 et seq.). By concentrating the assets of many cannabis businesses in one or several easily-identifiable CDIs, CDIs could be a target of federal law enforcement seeking to prosecute money laundering or drug trafficking cases. Potential insurers will likely factor this risk into the premiums they charge to insure a CDI.

### **What happens to CDIs if federal policy changes?**

As more states legalize cannabis activity, there is a growing conversation in Congress about potential changes to federal policy. Although no policy change appears imminent, there may soon be a time when traditional banks and credit unions can legally serve the cannabis industry. Upon sufficient federal policy change that lowers the risk for traditional financial institutions to serve the cannabis industry, it is reasonable to assume that cannabis businesses will desire the full suite of banking services that CDIs cannot offer – merchant accounts, electronic payments and funds transfer, and loan products. The threat of obsolescence – that a LCFI may be unnecessary in the near future if federal policy changes – could deter the private sector from investing the time and resources in pursuing a CDI charter.

### **How do account holders and owners of CDIs facilitate certain transactions?**

Due to the prohibition on banking activities between a CDI and a financial institution that does not hold a CDI charter, it is unclear how certain transactions would be conducted given that CDIs will have no mechanism for electronic funds transfer. For example, this bill permits

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<sup>3</sup> The difference between the interest received from loan assets and the interest paid for deposits and other funding sources

account holders to use special purpose checks to purchase state and local bonds. However, it seems unlikely that a bond dealer or broker would accept a special purpose check that the dealer or broker would need to redeem for cash at a CDI.

In another example, it is not clear how owners of CDIs will be able to receive dividends or other distributions of a CDI's profits. It appears that many transactions will require two or more steps, including withdrawing cash from a CDI and depositing that cash in an account with a traditional financial institution, which may expose account holders and payees to the type of violent criminal activity that this bill seeks to prevent.

The restriction on banking activities with traditional financial institutions could also complicate large cash transactions. A CDI would not be authorized to initiate an armored carrier transfer of cash to a traditional bank, so an account holder or owner of a CDI would be required to arrange the transfer. The traditional bank receiving the inbound cash would be required to comply with more complex filing requirements specified by the federal Financial Crimes Enforcement Network. A risk-averse receiving bank could decide to decline receipt of such cash shipments if the receiving bank was unable to verify that the CDI had adequate compliance procedures in place.

#### 5) DBO SUPERVISION PROVIDES PROTECTIONS

Despite the lack of clarity in this bill, some of the challenges outlined in the previous section can be partially resolved through rulemaking and supervision by DBO. Strong state oversight reduces the risk that unscrupulous actors would be able to establish a CDI to defraud or prey on cannabis businesses that are desperate for a banking solution. DBO uses a rigorous set of criteria when reviewing an applicant for a bank or credit union charter, and the department will heavily scrutinize an applicant's private insurer to verify that the insurance policy will be available to compensate depositors if the CDI encounters financial troubles. While state oversight cannot fix all of the structural challenges posed by this bill, regulation and oversight should prevent bad actors from taking advantage of businesses that have few alternatives.

#### **REGISTERED SUPPORT / OPPOSITION:**

##### **Support**

Bizfed - Los Angeles County  
Black American Political Association  
Board Of Equalization  
Brian Webster And Associates  
Calasian Chamber Of Commerce  
California Cannabis Industry Association  
California Cannabis Manufacturers Association  
California Growers Association  
California NORML  
Cannabis Distributors Association  
Clark Neubert  
CMG/Caliva  
El Capitan Advisors, LLC

Emeryville; City Of  
Fresno; City Of  
High Hampton Holdings  
Humboldt; County Of  
Infusion Factory  
Irvine; City Of  
Leafly  
Los Angeles; City Of  
Lovingly And Legally  
Monterey; County Of  
Port Of Hueneme  
River Distribution  
Rural County Representatives Of California  
Sacramento; City Of  
San Francisco, City  
Santa Monica; City Of  
Service Employees International Union, Local 1000  
Sespe Creek Collective  
Southern California Coalition  
Sparc  
State Board Of Equalization  
Sunstone Distribution  
Truth Enterprises  
We Drop  
Wurk

**Opposition**

None on file

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