

CONFLICT AND UNCERTAINTY:

Due diligence challenges for **marijuana**-related businesses

State and federal legislative and regulatory developments regarding marijuana continue to lead headlines across the U.S., with numerous states recently legalizing or beginning to debate potentially legalizing marijuana cultivation, distribution and consumption for medicinal and recreational purposes. Marijuana is now legal in 23 states, Washington, D.C., and the territories of Puerto Rico and Guam. In addition, 16 states have legalized the medical use of cannabidiol (CBD), one of the two main chemicals in marijuana, the other being tetrahydrocannabinol (THC). Polls increasingly show a majority of Americans supporting efforts to legalize and/or decriminalize the substance. One overriding condition that has not changed, however, is the continuing contradiction between federal and state laws concerning marijuana, which remains listed as a Schedule I drug by the Controlled Substance Act.¹ According to the Drug Enforcement Administration, Schedule I drugs are defined as drugs with no “currently accepted medical use and a high potential for abuse.”²

Moreover, marijuana-related businesses (MRBs) are still largely prohibited from accessing the products and services of banks. Their inability to obtain banking services has left most transactions to be conducted on a cash-intensive basis, creating an environment that is significantly vulnerable to violent crime, potential money laundering and tax evasion activities. MRBs have increasingly become reliant upon third-party private security companies to transport, protect and store their cash. This leaves open associated risks for MRB businesses, their staff, their customers and ultimately the general public at large. What’s more, financial institutions (FIs) should not be lulled into believing that MRBs operate on a 100 percent cash basis. Anecdotal evidence suggests that many MRBs in fact do have some access to financial services, including depository institutions, money services businesses (MSBs) and broker/dealers, among others. For example, in a poll of 78 state-licensed dispensaries in Colorado, Denver’s Fox31 found that 47 percent accepted credit card and/or debit card for payment, which necessitates a depository account to accept deposits.³ In addition, in Washington State, approximately 30 percent of marijuana sales taxes collected from MRBs are paid in cash, implying that the remaining 70 percent are paid via non-cash means. Similarly, in Colorado, approximately 50 percent of the marijuana sales taxes collected by the state from MRBs is paid in cash, implying that the remaining 50 percent is paid via non-cash means. In each instance, non-cash payments presumably require an interaction with a FI.^{4,5}

Due to this legal quandary, FIs face unique challenges and considerations specific to MRBs relative to other “legitimate” businesses. Whether or not FIs operate in one of the 23 legalized marijuana states or desire to serve MRBs, they all must maintain effective customer and enhanced due diligence (CDD/EDD) and know your customer (KYC) policies and procedures to meet Bank Secrecy Act/anti-money laundering (BSA/AML) regulations and guidance. Recall the legal and regulatory frameworks proposed by the U.S. Department of Justice’s (DOJ) “Cole Memo” released on August 29, 2013, and the Financial Crimes Enforcement Network’s (FinCEN) guidance FIN-2014-G001 released on February 14, 2014. FIs are tasked with balancing the BSA/AML requirements and the DOJ’s goals of restricting illicit distribution of marijuana with FinCEN’s directive of

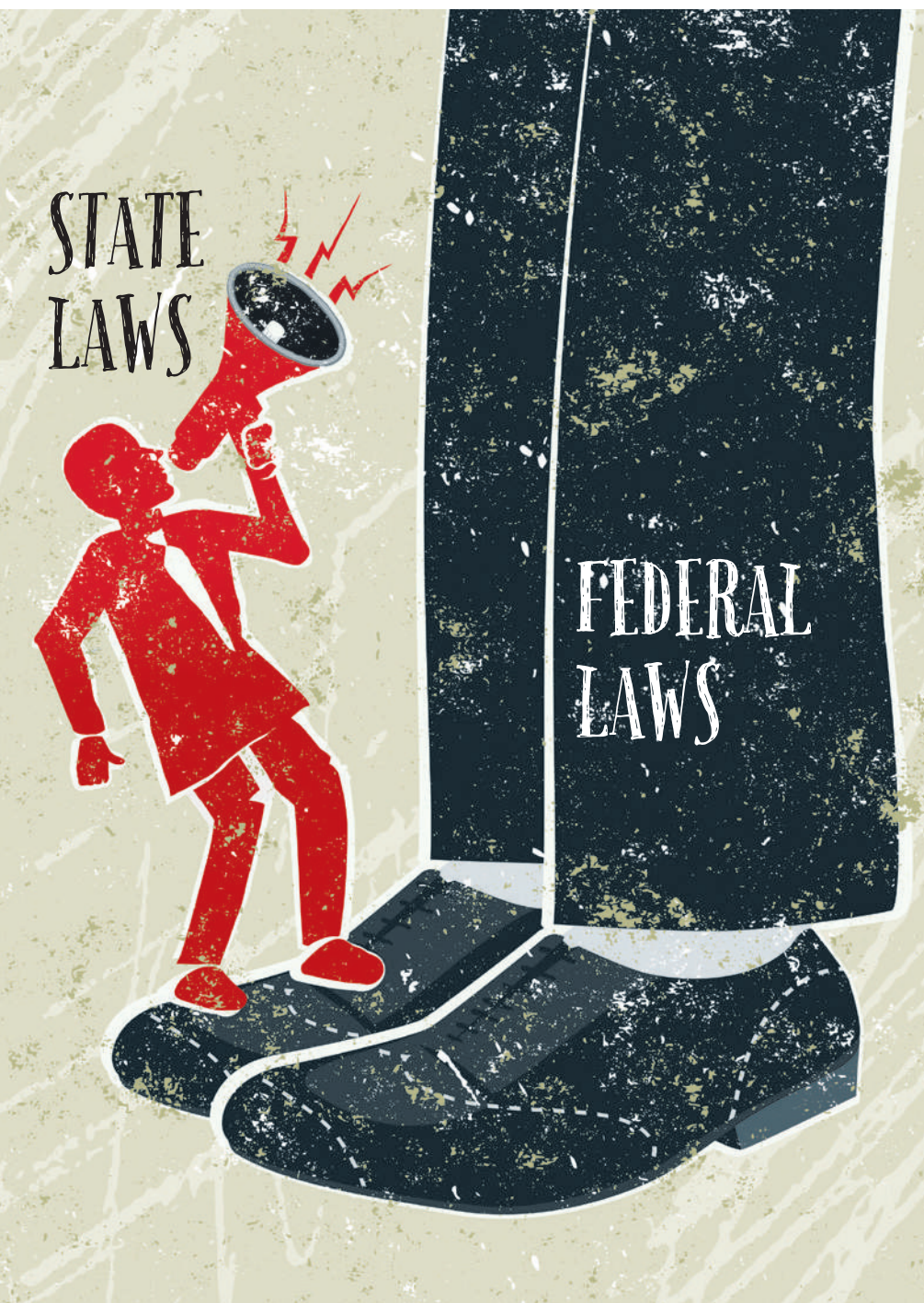
¹ U.S. Drug Enforcement Administration Drug Schedules, <http://www.justice.gov/dea/druginfo/ds.shtml>

² <http://www.dea.gov/druginfo/ds.shtml>

³ Chris Halsne, “Visa for pot: The credit card smokescreen,” FOX31 Denver, April 27, 2015, <http://kdvr.com/2015/04/27/visa-for-pot-the-credit-card-smokescreen/>

⁴ Noelle Crombie, “OLCC prepares to deal with cash-reliant marijuana industry,” *The Oregonian*, April 22, 2015, http://www.oregonlive.com/marijuana/index.ssf/2015/04/olcc_prepares_to_deal_with_cas.html

⁵ Christian and Vicente Sederberg, “7 Industry Data Points,” presented at the Spring Marijuana Business Conference and Expo, Chicago IL, *Marijuana Business Magazine*, Vol. 2, Issue 4, pg. 15, Jul-Aug 2015.



providing data and insight into the marijuana industry via “marijuana-related” suspicious activity reports (SARs), even if the company is legally licensed and regulated.^{6,7} These challenges and considerations extend well beyond legalized states and depository institutions considering that: 1) FIs in at least 42 states have submitted marijuana-related SARs (while only 23 states have legalized marijuana), and 2) at least 37 broker/dealers, 10 MSBs, four insurance providers and two casinos have filed marijuana-related SARs.⁸ In the current environment, FIs must consider a number of questions, but perhaps the most pertinent are:

1. How does one define an “MRB?”
2. “Are any of my existing or new customers MRBs themselves or are any of them exposed to any aspect of the marijuana industry via their customers?”
3. If so, how do we manage the risk?

FIs requirements to know their customers must take on the daunting mission of identifying MRBs. Public discussions generally define “MRBs” as marijuana growers, processors, distributors and dispensaries/retailers. Furthermore, in two proposed marijuana banking bills, the U.S. Congress defined “marijuana-related legitimate business” (MRLB) as “[a] manufacturer, producer or any person that (a) participates in any business or organized activity that involves handling marijuana or marijuana products, including cultivating, producing, manufacturing, selling, transporting, displaying, dispensing, distributing, or purchasing marijuana or marijuana products, and (b) engages in such activity pursuant to a law established by a State or a political subdivision of a State.”^{9,10} However, these definitions, as well as the proposed laws themselves, have potential limitations. First, many companies do not “touch” marijuana,

⁶ U.S. Department of Justice, “Guidance Regarding Marijuana Enforcement,” August 29, 2013, <http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf>

⁷ Financial Crimes Enforcement Network (FinCEN), FIN-2014-G001 “BSA Expectations Regarding Marijuana-Related Businesses,” February 14, 2014, http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf

⁸ Alison Jimenez, “Who is filing suspicious activity reports on the marijuana industry? New Data May Surprise You,” April 13, 2015, http://securitiesanalytcs.com/marijuana_SARs

⁹ U.S. Senate, S. 1726, July 9, 2015, <https://www.congress.gov/bill/114th-congress/senate-bill/1726/text>

¹⁰ U.S. House of Representatives, H. R. 2076, April 28, 2015, <https://www.govtrack.us/congress/bills/114/hr2076/text>

but are clearly “marijuana-related” and receive most/all of their revenues directly from the well-defined group of MRBs. Second, the proposed laws provide safe harbor only to banks and credit unions, so broker/dealers, MSBs and non-bank lenders, among other non-bank FIs, would apparently receive no such safe harbor protections.

According to recent analyses by both independent and industry researchers, the number of businesses that can clearly be identified as MRBs continues to grow. However, their exact number is hard to pin down, given several factors. First, there are varying degrees of reporting in legalized and regulated states (e.g., Arizona only provides licensed MRB information to registered qualifying patients); second, there are conditions of limited public reporting in legalized, but unregulated states (e.g., California); and third, the imprecise definition of “MRB,” as previously discussed, makes it difficult to identify all MRBs. For example, research conducted by Dow Jones Risk & Compliance indicates that there are nearly 3,000 MRBs and close to 4,500 associated individuals in the U.S. and Canada.¹¹ However, research by MRB Monitor indicates there are over 3,200 MRBs in the state of Washington alone and over 3,700 individuals with marijuana production licenses in the state of New Mexico.¹² Even in well-zoned urban geographic areas, the number of operating MRBs can be difficult to estimate. In Detroit, city officials estimate the number of medical dispensaries as “somewhere between 50 and 180.”¹³ This variance in data is indicative of how difficult it can be for FIs to know what constitutes an MRB, let alone identify one. In 2014, the Los Angeles, California finance office observed that over 450 marijuana shops filed renewals to pay taxes; however, more than 1,100 medical marijuana collectives were actively registered to

pay taxes—despite the fact that fewer than 140 medical marijuana businesses are eligible to stay open under city rules.¹⁴

These estimates also exclude thousands of businesses that support the marijuana industry and may not meet Congress’ strict definition, but clearly have significant exposure to, and accept large sums of money from, marijuana growers, processors, wholesalers and dispensaries/retailers. Whereas law enforcement might consider these ancillary companies to be “aiding and abetting” obvious MRBs, they also need to be closely monitored by FIs. For example, security companies hired by MRBs may transport marijuana for such customers, therefore meeting part (a) of the definition, but are generally not licensed or regulated by the state as an “MRB” per se, and thus fail to meet part (b) of the definition. There are also companies that do not necessarily meet either part of the definition, but clearly have huge exposure to the marijuana industry. Examples might include vendors selling growing apparatus and supplies, health clinics providing “recommendations” to medical users (because “prescribing” marijuana would still be illegal as a Schedule I drug), or third-party payment processors (e.g., non-depository FIs not covered by the proposed law’s safe harbor) that help MRBs accept credit card or “cashless ATM” payments. Whether or not any of these types of companies meet Congress’ strict definition of “MRLB,” they arguably all are “marijuana related” and thus presumably should be identified as such and subsequently monitored and reported as per FinCEN’s marijuana-related SAR filing requirements. Levels of due diligence applied to “Tier II” and “Tier III” MRBs (as seen in Graphic 1) may approach the threshold of knowing one’s customer’s customer (KYCC) as direct relationships become harder to define.

Arguably, as MRBs are brought into the light from the illicit side of narcotics sales and activity, marijuana growers, processors, distributors and dispensaries/retailers, most commonly discussed as MRBs, represent only the “tip of the iceberg” when considering due diligence requirements and policies and procedures planning. At this juncture, the capacity to distinguish “normal” commercial customers from those that may potentially be involved in some aspect of the marijuana industry is critical to developing, implementing and sustaining an effective risk assessment and CDD/EDD policies, procedures and processes. To aid in this analysis, FIs may seek to more specifically identify and categorize MRB businesses, owners and affiliated parties by type and develop appropriate tiers to manage MRB exposure as suggested below and within Graphic 1.

- **Tier I MRBs:** Companies that “touch” marijuana at any point from seed-to-sale. This generally correlates with the definition of “MRLB” in proposed federal legislation (e.g., growers, processors, wholesalers, dispensaries, etc.), although it also includes “illegitimate” marijuana businesses.
- **Tier II MRBs:** Companies that generally do not “touch” marijuana, but are focused on providing products and services specifically to Tier I MRBs and the marijuana industry as a whole. The majority of their revenue is expected to come from Tier I MRBs (e.g., suppliers, security firms, licensing consultants, etc.).
- **Tier III MRBs:** Companies that provide products and services to Tier I MRBs incidental to their core business. However, Tier I MRBs and the marijuana industry are not a focus and do not account for a majority of their revenue (e.g., professional services, landlords, financial services, etc.).

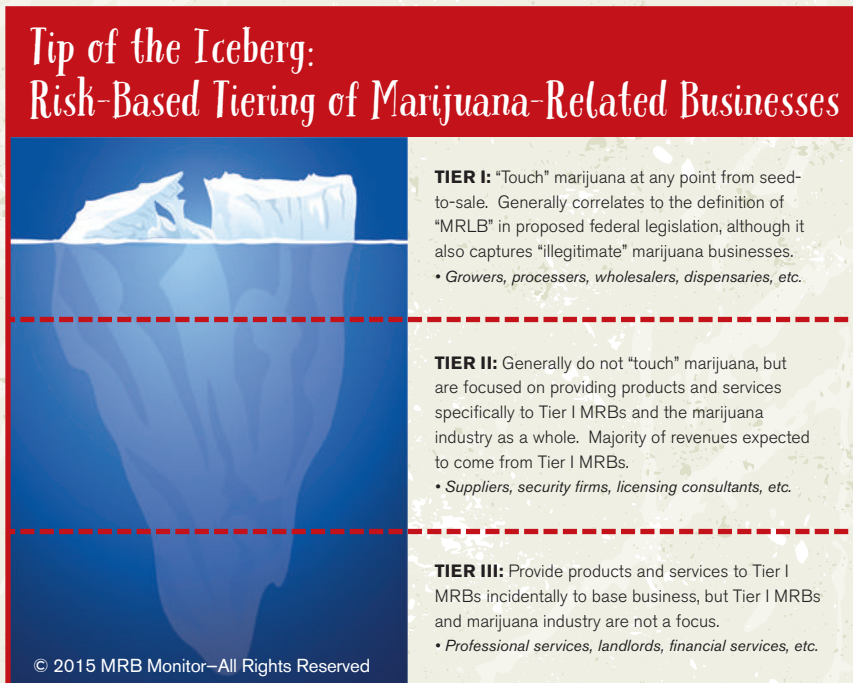
¹¹ Statistics courtesy of Dow Jones Risk and Compliance, <http://new.dowjones.com/products/risk-compliance/>

¹² Statistics courtesy of MRB Monitor, <http://mrbmonitor.com>

¹³ Bill Laitner and Joe Guillen, “Detroit officials want rules for medical pot shops,” *Detroit Free Press*, January 20, 2015, <http://www.freep.com/story/news/local/michigan/detroit/2015/01/20/medical-marijuana-dispensaries-cannabis-attorney-general-schuetz-detroit-regulations/22026453/>

¹⁴ Emily Alpert Reyes, “Tax filings give hint to number of marijuana shops in L.A.,” *Los Angeles Times*, April 2, 2014, <http://articles.latimes.com/2014/apr/02/local/la-me-marijuana-taxes-20140403>

Graphic 1



*Framework and graphic courtesy of MRB Monitor.

These general distinctions between business definitions within the context of MRB activity—although subject to interpretation—may serve as the first stage for FIs to attempt to identify, categorize and subsequently monitor those customers and account relationships that could present inherent risk to FIs as presented by the new and inherently higher risk MRB customer group. Only once FIs have a clearer understanding of what constitutes a "MRB" or "MRLB," can they even begin to consider the tens of thousands, if not hundreds of thousands, of marijuana-related individuals (MRIs), whether they are beneficial owners, management, or employees. Therefore, the degree to which beneficial and controlling owners and interests must be subject to due diligence remains a daunting task in the current legislative environment, particularly given the number of potential distinctions and scenarios presented by not only MRBs themselves but the individuals who stand behind them.

As the trajectory continues upward for the establishment of MRBs, FIs within states and territories where marijuana has been legalized must remain hyper-vigilant in their ability to identify, review and monitor legitimate business entities, owners and controlling parties. Early trends indicate that FIs within bordering states and territories, as well as FIs far from regions where marijuana has been legalized, must similarly remain vigilant for attempts by new or existing customers involved as indirect business entities, owners and controlling parties to MRBs as they may seek to invest or otherwise financially involve themselves in the business. Therefore, this condition may increase some customers' risk profiles, thus extending the challenge for all FIs to develop and maintain effective CDD/EDD and KYC policies, procedures and processes.

Thus far, attempts to establish alternative "credit union-like" cooperatives or other resources to serve as a substitution for traditional banking services for banking marijuana distributors and other related

businesses remain unresolved. As of July 31, 2015, efforts by the Fourth Corner Credit Union—backed by the governor of Colorado—have failed in attempts to obtain approval from the Federal Reserve for a "master account," which would permit interaction with other FIs as well as formalize banking services for some of the hundreds of licensed MRBs in the state. The credit union has filed a lawsuit against the Federal Reserve "demanding 'equal access' to the financial system," according to the *New York Times*.¹⁵

FinCEN guidance does not preclude future law enforcement action against an institution for providing banking services to MRBs even if a state has passed laws legalizing marijuana. Federal prosecutors could still bring action against a FI for providing banking services to MRBs, and this is the remaining open issue. FIs are still required to file SARs within 30 days of account opening for MRBs and every 90 days thereafter, or more often as circumstances warrant, and they are not eligible for consideration for filing exemptions with respect to a bank's currency transaction reporting obligations. Therefore, it is imperative that FIs maintain awareness and vigilance regarding both state and federal marijuana-based legislation as well as robust CDD/EDD and KYC programs in the months ahead, in order to ensure ongoing compliance with regulations and the law. **A**

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The views and opinions expressed herein are those of the authors and do not necessarily reflect the views and directives of the Federal Reserve Bank of Chicago nor the Federal Reserve System or any other banking regulatory agency.

¹⁵ Nathaniel Popper, "Banking for Pot Industry Hits a Roadblock," *New York Times*, July 31, 2015, http://www.nytimes.com/2015/07/31/business/dealbook/federal-reserve-denies-credit-union-for-cannabis.html?_r=0