THE BOND BUYER

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Bank Regulatory Issues Impede Cannabis Industry Financing Opportunities

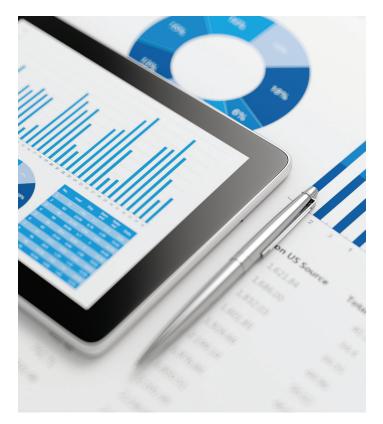
The nation's rapidly expanding legal cannabis industry, which operates in 24 states and the District of Columbia, faces a multibillion-dollar question: what to do with the millions of dollars in cash it collects each year?

To date, nearly all the nation's banks have refused to open accounts for hundreds of state-legal state cannabis businesses, leaving these businesses to operate almost entirely in cash. Governments, in turn, have difficulty monitoring criminal activity and properly collecting tax revenues.

This problem could reach alarming proportions soon if California becomes the next state to legalize the recreational use of marijuana, a distinct possibility with voters expected to consider a ballot measure in November and polling showing support for adopting the law. The state's legislative analyst recently estimated the marijuana industry could generate as much as \$1 billion per year in funds to state and local governments, but the ability to collect the true windfall could be severely hampered by regulatory obstacles for the banking industry.

While not on the same scale as projections for California, other states already may be encountering the loss of revenue from cannabis being primarily a cash business. Colorado, for example, collected more than \$85 million in marijuana tax revenues in 2016, according to the Colorado Department of Revenue. How much more would have been collected if cannabis were not primarily a cash business? States like Colorado will continue to forego revenue, as well as the opportunity to borrow against that revenue in the bond market, until the cannabis industry gains access to the banking system.

Marijuana has been a federal Schedule I drug, in the same class as heroin, since Congress passed the Controlled Substances Act in 1970. The law also makes



it illegal for financial institutions that depend on the Federal Reserve System's money transfer network to take any proceeds from cannabis sales. Understandably, banks hesitate to put themselves in jeopardy by opening accounts or receiving any money, even indirectly, from the sale of cannabis.

Since states began legalizing marijuana earlier this century, regulators have taken halting steps toward opening up the banking system to the cannabis industry. On Aug. 29, 2013, the U.S. Department of Justice issued the so-called "Cole Memo", signed by Deputy Attorney General James Cole, suggesting that banks may not face criminal prosecution if they only serve cannabis businesses legal under state law. On Feb. 14, 2014, the Department of Justice issued a supplement to the Cole Memo, while on the same day the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Department of the Treasury charged with safeguarding the financial system from illicit use and combating money laundering, issued formal guidance building on the Cole memo. Each of these documents recites key elements of the Controlled Substances Act and dutifully states that marijuana is a dangerous drug, the distribution and sale of which is a serious crime. Each also hints and suggests that regulators and law enforcement may, within limits, look the other way where cannabis is concerned.

One can see and even sympathize with the regulators' predicament: how to provide commonsense solutions to a real problem while at the same time upholding federal law? The Cole Memo directs Department of Justice attorneys and law enforcement to focus their enforcement resources on persons or organizations whose conduct interferes with one or more of eight priorities identified in the memo. This suggests that prosecutors should look the other way, even where financial institutions technically violate the law, so long as their activities do not impinge on the eight priorities. The memo postulates state-level regulatory systems designed to minimize harm from the cannabis industry and goes on to say "...In those circumstances, consistent with the tradition allocation of federal-state efforts in this area, enforcement of state law by state and local law enforcement and regulatory bodies should remain the primary means of addressing marijuana-related activity."

Similarly, the FinCEN guidance suggests a sort of workaround of federal drug laws by implementing a robust set of customer due diligence procedures, including the requirement to file compliance reports, also known as suspicious activity reports, or SARs, on each customer. Specifics are provided as to how to file SARs for marijuana-related businesses. The guidance says it "...clarifies how financial institutions can provide services to marijuana-related businesses consistent with their [Bank Secrecy Act] obligations" and concludes with the following statement: "FinCEN's enforcement priorities in connection with this guidance will focus on matters of systemic or significant failures, and not isolated lapses in technical compliance."

Unfortunately, regulatory winks and nods of this kind have not, to date, enticed banks to open their doors en masse to the cannabis industry.

What about the courts? In November 2014, the State of Colorado chartered the Fourth Corner Credit Union in Denver, which was formed for the exclusive purpose of providing banking services to cannabis businesses. Receiving a state charter allowed Fourth Corner to acquire a bank routing number and to apply directly to the Federal Reserve Bank of Kansas City, the regional bank for the board of governors of the Federal Reserve System, for a master account, which is necessary to facilitate the electronic transfer of funds and for a bank to provide basic banking services. Fourth Corner then filed a lawsuit against the Federal Reserve in U.S. District Court demanding equal access to the financial system.

In January 2016, the court ruled that the Federal Reserve Bank could not be compelled to grant Fourth Corner Credit Union a master account. Fourth Corner is appealing this ruling. The National Credit Unit Administration ("NCUA") similarly informed Fourth Corner that it was ineligible for share insurance because it had failed to prove to NCUA's satisfaction how Fourth Corner would mitigate their risk associated with serving a single industry that does not have an established track record of success and remains illegal at the Federal level. Fourth Corner filed a separate suit against the NCUA, alleging that the agency violated its rights to due process under Federal law. That case is still pending.

Meanwhile, banks and cannabis business are resorting to all manner of alternative methods to accommodate day to day operations, such as virtual currency, cashless ATM/Debit machines and point of sale readers, investment funds and pre-paid smart cards. These alternative banking methods are not an ideal or a

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sustainable solution, however, as they tend to foster black markets and criminal activity.

The cannabis industry is growing and it appears to be here to stay. As it grows, tax revenue will grow. As tax revenue grows, governments will seek access to the bond market to monetize those revenue streams and free up capital for harm mitigation and other projects. Marijuana revenue bonds will be the new tobacco bonds, except that while cigarette consumption is declining, cannabis sales are booming. The first step in this process, which is also crucial to curtailing unwanted and unnecessary criminal activity, is to give the cannabis industry access to our nation's banking system.

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