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Compliance and the New York Cannabis Market: What Your Clients Should Be Doing Right Now

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What Your Clients Should Be Doing Right Now

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Road Map

- MRTA and the Coming New York Cannabis Market
- New York's Competitive Licensing Scheme
- Diversion/Inversion & Enforcement
- Building a Robust Compliance Program

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The MRTA and the Coming New York Cannabis Market

The Marijuana Regulation and Taxation Act of 2021 ("MRTA") sketches out the framework for New York's legal adult-use cannabis market, but leaves crucial details to be filled in later.

The Marijuana Regulation and Taxation Act of 2021

- In March 2021, the New York state legislature passed and then-Governor Cuomo signed the MRTA.
  - Codified as the Cannabis Law, Chapter 7-A of the New York Consolidated Laws.

- The law ended New York's prohibition on adult possession and use of recreational cannabis in personal quantities.

- But while MRTA may "legalize" cannabis for the average user, it does **not** create a free-for-all: personal possession is limited to three ounces of cannabis or 24 grams of concentrated cannabis.
  - Personal possession of more than five pounds of cannabis (or two pounds of concentrate) is still a felony!

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The New York Cannabis Market

- New York is the fourth-largest state by population and the second-largest, after California, to have legalized adult-use cannabis.
  - The second- and third-largest states, Texas and Florida, have not given any signs that they are likely to legalize adult-use cannabis in the near future.

- Unlike the crowded and hypercompetitive cannabis markets in West Coast states with established cannabis industries, New York's legal cannabis market represents one of the best upcoming opportunities for a "green rush."

- New York is estimated to generate $3.7 billion in legal sales in 2025.
  - https://www.axios.com/new-york-cannabis-legalization-marijuana-market-california-global-a484d2ed-92b2-4e80-a209-95fcac8d2a4d.html

MRTA and the Commercial Market

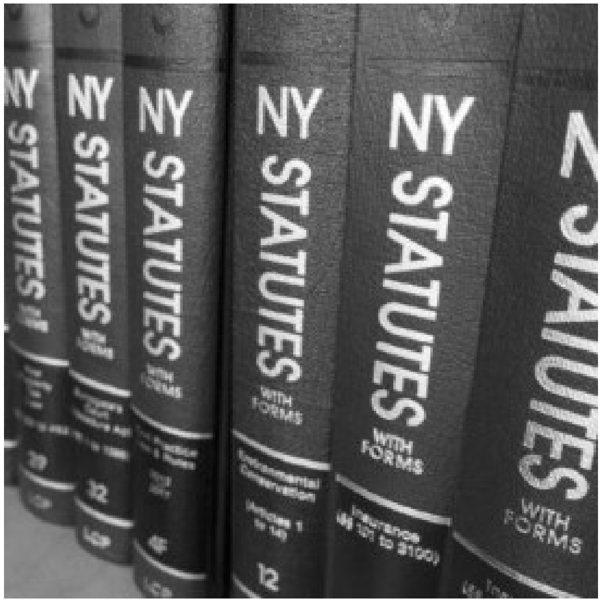
- Although MRTA legalized personal possession and use immediately, commercial operations are a different story.

- MRTA legalizes the commercial production and sale of cannabis only by **licensed** persons—unlicensed cultivation, distribution or sale of cannabis is and will remain against the law.
  - MRTA § 125.1 ("No person shall cultivate, process, distribute for sale or sell at wholesale or retail or deliver to consumers any cannabis, cannabis product, medical cannabis or cannabinoid hemp or hemp extract product without obtaining the appropriate registration, license, or permit therefor required by this chapter unless otherwise authorized by law.").
  - Currently a legal gray area, but will not remain one.

- **Licensing is likely to be highly competitive.**

Implementing Regulations

- MRTA is not a short statute—it runs to 128 PDF pages of legislative text.
- Notwithstanding that level of detail, New York's legal adult-use cannabis market will not be operational until New York adopts implementing regulations, including licensing.
- Although it has been nearly a year since MRTA's passage, these regulations have still not yet been promulgated.



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The Cannabis Control Board

- Responsibility for writing New York's adult-use cannabis regulations lies with a new state agency created by MRTA, the Cannabis Control Board ("CCB").
  - *See* MRTA § 10 ("Powers and duties of the cannabis control board").

- CCB, in addition to writing the regulations, will grant or deny necessary licenses, oversee compliance, and employ its own investigators to enforce the cannabis laws.

- The five-member board had its first public meeting on October 5, 2021, and has met several times since.

- The market is estimated to go live in late 2022 or 2023.

Key Takeaways

- New York's legal adult-use cannabis market stands to be extremely profitable, but is not yet open for commercial operations.
- Only licensed cultivators, distributors, and retailers will be able to legally operate in New York.
- Although there are still many details left for the CCB to work out in regulation, there is enough information in MRTA itself to put license applicants on notice of what it will take to win one.

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New York's Competitive Licensing Scheme

A proactive compliance program will be a distinguishing feature in the competitive scramble for cannabis licenses.

New York’s Licensing Scheme

- Aspiring cannabis businesses in New York will have to navigate a fine-grained licensing scheme, even under MRTA alone.

- MRTA establishes, depending on how you count, at least nine different types of licenses, applicable to different levels of the supply chain:
  - **Suppliers:** Adult-use cultivator (§ 68); “Nursery,” which authorizes the production and sale of clones, immature plants, seeds, etc., to other licensed cultivators, cooperatives, or microbusinesses (§ 75).
  - **Distributors:** Adult-use distributor (§ 71); Adult-use processor (§ 69).
  - **Retailers:** Adult-use retail dispensary (§ 72); Adult-use on-site consumption (§ 77); Delivery (§ 74).
  - **Small, Vertically Integrated Businesses:**
    - “Adult-use cooperative,” which allows a cannabis business organized as a democratic cooperative to acquire, cultivate, process, and sell cannabis to distributors and retail dispensaries, but not directly to consumers (§ 70).
    - “Microbusiness,” an all-in-one license category for small businesses to produce and sell their own cannabis within limits to be set by CCB (§ 73).

New York's Licensing Scheme

- Each of these categories has its own particular requirements and prohibitions.
  - Many license categories contain strict limits on vertical and horizontal integration—for example, the holder of an adult-use cultivator license may also apply for a processor and a distributor license (for their own products), but is prohibited from holding a license or any financial interest whatsoever in any retail dispensary, or from holding any interest in more than one cultivator license (§ 68.3–5).
  - For a full list of vertical integration limitations, *see* "What is in the Law—Adult-Use License Types," cannabis.ny.gov.
- There are separate (and more capacious) license categories available for the ten license holders in New York's existing medical cannabis regime.

New York's Licensing Scheme

- MRTA emphasizes that licenses are to be granted at CCB's discretion and that "it is a privilege, not a right, to cultivate, process, distribute, and sell adult-use cannabis." (§ 64.1(g)(i)).

- Licenses are granted to a specific person for a specific premises and are **non-transferrable** to any other person or any other premises without the approval of CCB (§§ 126.1, 128.1).
  - **Your clients should make sure to resolve any facility/land use issues before they apply for the permit!**

- Licensees will be "held strictly accountable for any and all violations that occur" upon the premises, and "for any and all violations committed by or permitted by any manager, agent or employee" of the licensee. (§ 125.8).

Reasons for Competitiveness

- Despite the intricacies of New York's adult-use cannabis regime, several features of MRTA make it likely that licenses will be highly competitive.

  - CCB is authorized (but not required, as in some other states) to cap the number of each type of license it will grant (§ 10.2).
  - MRTA gave municipalities until 12/31/21 to opt out of having retail dispensaries or consumption sites (or both) within their limits (§ 131). At least 753 of New York's 1521 municipalities (49.5%) have opted out of having retail dispensaries, and at least 857 (56.3%) have opted out of consumption sites.
    - For a full list of municipalities that have opted out, see https://rockinst.org/issue-areas/state-local-government/municipal-opt-out-tracker/.
    - No part of New York City appears to have opted out.

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Reasons for Competitiveness

- "A goal shall be established to award fifty percent of adult-use cannabis licenses to social and economic equity applicants" (§ 87.2):
  - Individuals from communities disproportionately impacted by the enforcement of cannabis prohibition;
  - Minority- and women-owned businesses;
  - Distressed farmers; and
  - Service-disabled veterans.
- Governor Hochul has committed to creating a $200 million public-private fund to support "social and economic equity" applicants.
  - https://www.marijuanamoment.net/new-york-governor-announces-200-million-marijuana-fund-to-promote-industry-equity/
- A licensee that does not qualify as a "social and economic equity" applicant is automatically competing for half as many licenses.

Compliance as Competitive Advantage

- Two of the key criteria CCB will use to evaluate license applications relate to compliance (§ 64.1(b)–(c)):
  - "[T]he applicant will be able to maintain effective control against the illegal diversion or inversion of cannabis."
  - "[T]he applicant will be able to comply with all applicable state laws and regulations."
  - Other criteria include the applicant's readiness to begin operations, the applicant's good moral character, and the public interest in having the proposed facility (or not).

- MRTA contains concrete, actionable requirements on subjects such as record keeping (§ 78), packaging (§ 81), and laboratory testing (§ 82), and specific rules applicable to different license types (*see*, *e.g.*, §§ 83–85).

- To put themselves in the best competitive position, potential license applicants can and should start efforts to comply with these known requirements **now**—there will be plenty more to do once CCB releases its regulations!

- Unsuccessful applicants may not get a second bite at the apple.

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Key Takeaways

- Commercial cannabis operators in New York will have to navigate a detailed, complex licensing scheme.
- Success or failure is almost entirely at the discretion of the CCB.
- The number of licenses to be granted is likely to be limited both by geography and CCB policy, especially for applicants that don't qualify as "social or economic equity" applicants.
- Compliance is a key factor in CCB's licensing decisions, so potential applicants that take action now based on MRTA's known requirements will have a leg up when it's time to apply.

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Diversion/Inversion & Enforcement

Licensees will have to prove that they are able to prevent diversion and inversion of legal cannabis to the illegal market.

Diversion & Inversion

- **Diversion** occurs when legal cannabis is diverted to the illegal market; **inversion** occurs when illegal cannabis is fraudulently introduced into the legal market.

- The temptation for diversion/inversion boils down to the simple fact that the illegal market has no taxes or regulation, so cannabis can be sold at a lower price and/or higher profit than in the legal market.
  - Cultivators, distributors and retailers will be tempted to dump excess supply into the illegal market.
  - Downstream licensees such as distributors and retail dispensaries will be tempted to invert cheaper illegal cannabis.

- Diversion is an omnipresent concern in other highly-regulated markets, such as opioids and tobacco.

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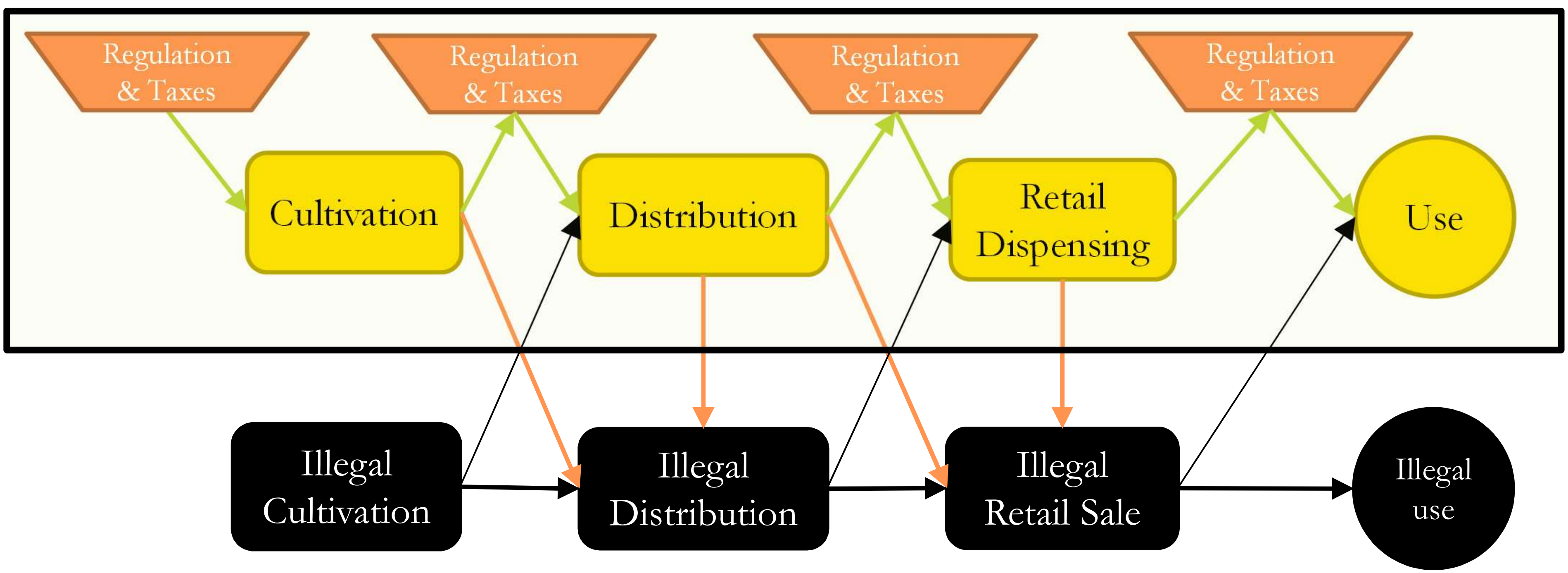
Opportunities for Diversion/Inversion

Legal Market



Illegal Market

New York Diversion/Inversion Incentives

- New York's illegal market is large and will not easily be absorbed.
  - The estimated size of the illegal market is $1.74 to $3.5 billion per year.
- Illegal cannabis will be cheaper in New York.
  - In the illegal market, an ounce sells for an average of $270 to $340.
  - In the legal market, an ounce is expected to sell for at least 10% higher, if not more.
  - https://cannabis.ny.gov/system/files/documents/2021/09/marijuana_legalization_impact_assessment_7-13-18.pdf
- Cheaper prices drive consumers to the illegal market.
- Higher profits drive suppliers, distributors and retailers to the illegal market.

Diversion in Other States

- In California, five years after legalization, the illegal cannabis market is still 2.5x the size of the legal market ($10 billion vs. $ 4 billion).
  - Diversion is, in part, feeding the illegal market.
  - Oversupply in California has caused wholesale legal cannabis prices to drop from $1,000 to $300/pound—with a $150/pound cultivation tax.
    - *See* Michael R. Blood, *Double Dealing: Legal, Illicit Blur in California Pot Market*, SFGATE (Jan. 16, 2022).
- By 2019, Oregon's legal cannabis market produced twice as much cannabis as consumers were using, leading to strong incentives for diversion.
- In 2017, former Attorney General Jeff Sessions threatened to crack down on Washington over the diversion of medical cannabis to other states and minors.

State & Federal Enforcement

- Because diversion and inversion deprives authorities of tax revenue—in addition to feeding the illegal market, supporting organized crime, and giving minors access to controlled substances—they have a strong incentive to penalize it.
- Civil and criminal penalties could be imposed at the state and federal levels.
- Enforcement efforts are likely to become **more**, rather than less, intense over time as legal cannabis becomes more established.

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MRTA and Anti-Diversion/Inversion Enforcement

- In addition to being a key factor in CCB's licensing decisions (§ 64.1(b)), anti-diversion/inversion is a central part of MRTA's adult-use cannabis regime:
  - CCB is required to promulgate rules to prevent illegal diversion and inversion (§ 13.3).
  - Diversion or "failure to adequately prevent diversion" is cause for CCB to revoke a license and may result in civil penalties (§ 133).
  - Recall that licensees are held "strictly accountable" for all violations that occur on their premises or by their managers or employees (§ 125.8).

- Unlicensed sale of cannabis remains a crime in New York.
  - The aggravated criminal sale of more than 100 pounds of cannabis is a felony, punishable by up to 15 years in prison. (N.Y. Penal Law §§ 70.00(c)(2); 222.65).

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The Feds & Anti-Diversion/Inversion Enforcement

- Federal law and policy (the Cole Memorandum and the Rohrabacher-Farr Amendment) effectively prohibit DOJ from prosecuting cannabis businesses operating in accordance with state law (though DOJ still can and does prosecute illegal diversion).

- But all recent legislative proposals for federal cannabis legalization (the MORE Act, CAOA, etc.) retain anti-diversion/inversion provisions, sometimes quite extensive ones.

- The potential end of DOJ's current noninterference policies after federal legalization may cause DOJ to become more active in policing diversion/inversion from legal cannabis markets, especially across state lines.

The Feds & Anti-Diversion/Inversion Enforcement

- For example, the Controlled Substances Act contains anti-diversion provisions (including affirmative reporting requirements), and DOJ has prosecuted distributors, as well as doctors and pharmacies, involved in the illegal diversion of opioids.

- The ATF, under the Contraband Cigarette Trafficking Act, focuses closely on the interstate diversion of cigarettes and other tobacco products, especially from areas with low excise taxes (like Virginia) to high-tax areas (like New York City).

Key Takeaways

- As the legal cannabis market evolves, compliance efforts are only going to become more important.
- Illegal diversion/inversion opens up licensees to existential business risk and, potentially, serious criminal penalties.
- Both state and federal regulators have strong enforcement weapons in their arsenals, which they are expected to use.

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Building a Robust Compliance Program

Experience from other industries suggests important immediate steps.

Building a Robust Compliance Program

- The first place to check is MRTA itself, including the sections related to your client's license type.

- Any requirement in MRTA won't change when the CCB issues regulations—take care of it now!

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Building a Robust Compliance Program

- Experience from other industries suggests general best practices:
  - Create explicit and written anti-diversion/inversion protocols.
  - Train employees on those protocols and the seriousness of the risk diversion/inversion represents (you could be shut down!).
  - Establish an independent compliance department separate from sales team.
  - Establish "know your customer" (KYC) protocols, including site visits and review of the customer's license, written policies and other relevant records (if applicable).
  - Establish a procedure to monitor orders for signs of diversion/inversion.
    - "Seed-to-Sale tracking": a comprehensive inventory control software/tagging system that tracks cannabis through cultivation, processing, distribution, and sale. **<u>But</u>** Seed-to-Sale tracking isn't a cure-all—it's still possible for product to "go missing."
    - By comparison, similar systems for tracking opioids (ARCOS) have not prevented diversion.
  - Establish mechanisms for quickly and fully reporting suspected diversion/inversion both internally and to the relevant authorities.

Understand Potential Red Flags

- Inadequate or non-existent compliance procedures.
- Irregular or sparse bookkeeping, especially for cash sales.
- Unexpectedly large cash revenue, given volume of legal sales.
- Understatement of product quantities on paperwork.
- Unexplained discrepancies in product packaging, characteristics, quality, or potency.
- Consistent reports of low yield or high wastage in seed-to-sale tracking systems.
- Inconsistent transaction reporting or frequent "mistakes" in seed-to-sale system.
- Untagged cannabis present on premises.
- Product or purchase offered at unexpectedly good prices, especially large quantities.
- Unfamiliar/unlicensed third parties, especially if exhibiting suspicious behavior.
- Business activities at unusual hours.
- Unusual employee behavior (e.g., lavish lifestyle, unauthorized access, lax oversight).

Steps for Attorneys to Mitigate Risks

- Document and ask questions
  - Avoid "willful blindness"
- For clients seeking licenses:
  - Explain compliance as a competitive advantage in licensing.
  - Collect necessary information on planning and operations now, and explain why.
  - Ensure client understands risks of diversion and inversion, including loss of license, civil penalties and criminal prosecution.
  - Assist in drafting anti-diversion/inversion policies and training materials.
  - Stay on top of developments as CCB drafts regulations, keep the client informed, and be ready to amend plans as the regulations take shape.

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Key Takeaways

- Clients should establish formal and robust compliance programs to combat diversion and inversion.
- Failing to address red flags of diversion and inversion can lead to costly regulatory investigations and penalties.
- Taking anti-diversion/inversion seriously **now** will give your clients the best chance of getting—and keeping—a license to operate in New York's cannabis market.

Questions?

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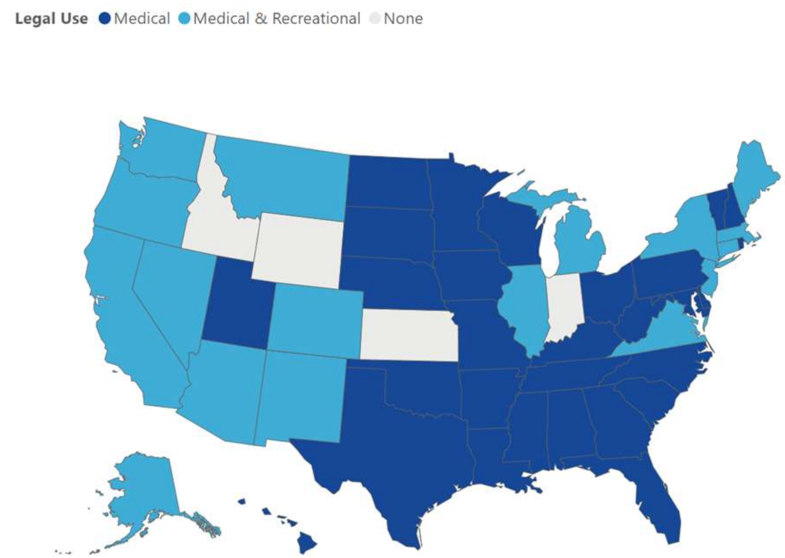
About Ballard Spahr

- We are a national firm in offices across the country, with over 600 lawyers.
- Our attorneys provide counseling and advocacy in more than 40 areas including litigation, real estate, business and finance, securities, and tax.
- Ballard Spahr's Cannabis Team has advised growers, dispensaries, technology companies, researchers and investors on a variety of regulatory, licensing, corporate, financing, intellectual property, and other legal issues.
- Please see Ballard Spahr's Cannabis Legislation Tracker to stay abreast of new legislative developments at the state and federal level.



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Michael P. Robotti

- Mike is a litigation partner in Ballard Spahr's New York office. He is a member of the firm's White Collar Defense & Internal Investigations Group and its Cannabis Team.
- Mike is a former Assistant United States Attorney in the Eastern District of New York. During his nearly eight years there, Mike served as deputy chief of the International Narcotics & Money Laundering section and as senior trial counsel for the Business and Securities Fraud section. Mike was a member of the trial team that prosecuted Joaquín "El Chapo" Guzmán Loera, the leader of the Sinaloa Cartel.
- Mike uses his strong prosecutorial background to handle internal and government investigations, white collar defense and complex litigation, counseling corporations and individuals across a range of industries.
- Mike also advises financial institutions and businesses on their compliance obligations, focusing on issues involving money laundering, cannabis, cryptocurrency and corruption. Mike assists businesses presently seeking to enter New York's cannabis market with preparing their compliance plans and licensing applications. He has co-authored several recent articles on this topic, included here as supplemental materials.

Shawn F. Summers

- Shawn is a litigation associate in the Philadelphia office of Ballard Spahr. He advises clients dealing with federal regulatory issues including potential sanctions exposure and voluntary self-disclosure. His practice also includes civil commercial litigation, First Amendment media defense, and political/election law.

- Shawn is a member of Ballard Spahr's Cannabis Team and Political & Election Law Team.

- Shawn previously co-authored several articles on the cannabis industry, which are included here as supplemental materials.

Thank you!

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THE NEW YORK LAW JOURNAL

Joint Defense: The Need for Prospective New York Cannabis Companies to Implement Strong Compliance Programs Now

October 22, 2021

By Michael P. Robotti and Shawn F. Summers

Cannabis companies vying for highly competitive New York licenses will want to prove their compliance readiness during the application process; and if they want to stay in the market, they will need to demonstrate their commitment to compliance once in operation.

Marijuana prohibition in New York ended in 2021, but it is a bit of a misnomer to say that the state has "legalized marijuana." The Marijuana Regulation and Taxation Act of 2021 (MRTA) did not legalize *all* marijuana distribution under New York law; rather, it legalized only *licensed* distribution. The state plans to tightly regulate that licensed market, and cannabis companies will face stiff penalties for unlicensed distribution. To avoid those penalties, they have a strong incentive to create comprehensive compliance programs. But potential penalties aside, cannabis companies vying for highly competitive New York licenses will want to prove their compliance readiness during the application process; and if they want to stay in the market, they will need to demonstrate their commitment to compliance once in operation. Prospective licensees thus should be taking steps now to ensure they are ready to compete for licenses in 2022.

The MRTA

On March 31, 2021, then-Gov. Andrew Cuomo signed the MRTA, passing sweeping legislation that ended cannabis prohibition in New York and laid out the framework for its legal cannabis market. But Governor Cuomo did little to implement the legislation during the subsequent six months. Cuomo's successor, Gov. Kathy Hochul, however, has made implementing the MRTA a priority, since assuming office in August 2021. She and the legislature have appointed the members of New York's Office of Cannabis Management Control Board (Board)—a critical first step, as the Board has authority to craft regulations and grant licenses. The Board's first meeting took place on October 5.

Even with this recent progress, though, implementation is still going to take time. The Board still must hire and train staff, issue and adopt regulations and develop the licensing process. See "What is in the Law—Adult-Use License Types," cannabis.ny.gov. Estimates as to when the New York market will go live now range from late 2022 to 2023. This longer-than-anticipated delay, however, should not deter potential license applicants from preparing to enter the market. Although the Board has not yet issued its regulations, the MRTA offers much guidance to companies planning to enter the New York cannabis market.

The Licensing Scheme

The MRTA establishes a detailed licensing scheme for the legal cannabis market. The state will confer licenses at each level of the supply chain. See id. Suppliers may apply for a cultivator license that permits them to grow cannabis for distribution, as well as a nursery license that allows them to sell seeds and immature plants. Processors may apply for a license that permits them to manufacture concentrated cannabis or cannabis products for wholesale distribution. Wholesale distributors may apply for a license that permits them to obtain processed cannabis at wholesale for the purpose of distributing it to retailers. For retail distribution to consumers, the law establishes different licenses for (1) retail distribution from a commercial dispensary; (2) retail distribution for the purpose of use on-site at a dispensary; and (3) delivery directly to consumers. The MRTA also creates separate licenses for certain cannabis business types known as "cooperatives" and "microbusinesses." Finally, it establishes separate licenses for cannabis businesses that already participate in New York's medical marijuana market.

New York Licenses Will Be Highly Competitive

The competition for a New York license is likely to be fierce. The market is expected to be extremely lucrative: it is projected to be worth $1.2 billion in 2023 and, by 2027, $4.2 billion. These financial prospects are likely to set off a "green rush" for New York licenses. Coupled with these huge financial incentives, though, is the reality that the MRTA contains numerous limitations on the granting of licenses. That means that only a portion of the companies that want these lucrative licenses are likely to get them. Here's why.

The Board may limit the number of each license type that it grants, although the law does not require it to do so. See MRTA §10.2. It is still too early to tell if the Board will impose caps. Other states with legal recreational markets have taken different approaches. For example, Virginia and Illinois have license caps throughout the supply chain. By contrast, California has eschewed statewide license caps, although it permits localities to implement their own. It is quite possible that, like some other states, the Board will impose limits.

The MRTA also establishes potential geographic limitations that may reduce the number of available licenses. Municipalities have the opportunity to opt out of retail establishments by year's end, and some already have taken steps to do so. Id. §131. Additionally, in deciding whether to issue a license, the Board may consider the concentration of licensed locations already in the area. Id. §64(g)(ii). Applicants for certain retail licenses also must notify the local government or, in New York City, the community board where the premises will be located. Id. §76. The governing body then has the opportunity to weigh in on the license application. Id. §76.4. These geographic restrictions may lead to a reduction in the overall number of licenses issued.

Regardless of how many licenses it grants, the Board will seek to issue 50% of each type of license to "social and economic equity applicants," which includes minority- and women-owned businesses, distressed farmers and service-disabled veteran owned businesses. Id. §10.2. Moreover, the MRTA largely prohibits vertical integration and bars a licensee from owning more than a certain number of the same licenses. See id. §§68.4-5, 69.4, 73.2, 74; "What is in the Law—Adult-Use License Types," cannabis.ny.gov. The purpose of these limitations is to prevent large, vertically integrated companies from gobbling up the majority of the market. See "What is in the Law—Social and Economic Equity," cannabis.ny.gov. Taken together, these provisions aim to reduce barriers to entry in the market and create a competitive and diverse group of applicants. Id.

Notably, though, cannabis companies already operating in the legal market for medical cannabis may have a leg up on new applicants. See Debra Borchardt, "New York State's Original 10 Cannabis Companies are Big Winners," Real Money (March 31, 2021). The Board may grant these companies unique licenses, which exempt them from some restrictions faced by new entrants into the market. In particular, because they already are vertically integrated, they will be grandfathered into the new system in their current structure. With their experience in New York's existing market, the Board is likely to grant recreational licenses to these companies. Given their structural advantage and multiyear head start, they are positioned to be major players in the new market. This transition of medical cannabis companies into the recreational market may further reduce the number of licenses the Board grants to new entrants.

With a limited number of licenses, a crowded field of applicants and established players at an advantage, obtaining a New York license could be tough. And, for those companies to which the Board does not grant initial licenses, it is unclear when they will get a second bite at the apple. The Board will have discretion to decide whether and when to grant additional licenses or authorize the resale of licenses. See MRTA §§10.19, 13.2(g), 62.8, 67.3, 87.7, 126. At this point, then, it is unclear when a cannabis company will have the opportunity to reapply for or purchase a license. Applicants should not assume they will get more than one shot at a license in coming years.

The Need to Be Compliance Ready

Cannabis companies that do obtain New York licenses will be subject to a comprehensive regulatory regime. License applicants will need to demonstrate their readiness for such regulation during the application process. Successful applicants also will need to implement adequate compliance procedures right away. The Board will evaluate their compliance procedures not only during the initial licensed period—with the power to suspend or revoke licenses for inadequate compliance—but also when considering license renewal applications every two years. Developing and implementing adequate compliance procedures thus should be a top priority for potential entrants into the New York market. Indeed, to increase the odds of a successful entry into the New York market, cannabis companies should strive to make their compliance programs the industry gold standard.

The MRTA identifies important areas that the Board will regulate. For instance, the Board will establish regulations relating to books and records; methods of producing, processing and packaging cannabis; security requirements for licensed locations; ownership transparency; and employment requirements. Id. §§13.2-3; 137.1(a)-(b). It also will establish broad anti-diversion regulations, to prevent diversion of cannabis from the legal market to the illegal market, including regulations that prevent distribution of cannabis to persons under 21; revenue from the sale of cannabis from going to criminal enterprises; New York cannabis from going to other states and vice versa; and legal cannabis activity from being used as "a cover or pretext for the trafficking of other illegal drugs or other illegal activity." Id. §13.3.

While the Board will articulate the full criteria for granting licenses, the statute provides certain baseline considerations, many of which require the Board to evaluate an applicant's ability to comply with the law's regulatory scheme. See id. §64.1(b)-(d), (g)(viii). It will be the responsibility of the licensee to ensure that it meets the law's requirements; in fact, licensees will be "held strictly accountable for any and all violations" on their premises or committed by their employees. Id. §125.8.

To detect violations of the law's provisions, the Board will have broad inspection authority. Id. §§10.7-8, 11.3, 11.5, 13.2(c). Licensees found to be in violation of those provisions face a range of penalties. On top of civil and criminal penalties, the Board also may suspend, cancel and/or revoke the license. Id. §§132, 133.3-5. It also may ban the licensee from selling cannabis in New York for a one-year period, seek an injunction against such a company from selling cannabis in the state and decline to renew its license. Id. §§125.9, 137.1(d)-(f), 138-a. In short, from a business perspective, the consequences of violating the law could be devastating, jeopardizing a company's ability to operate in New York at all.

The range of available penalties certainly will incentivize potential entrants into the New York market to develop and implement policies that ensure compliance with the MRTA. But beyond avoiding potential penalties for noncompliance, cannabis companies have additional incentives to ensure their compliance procedures go far beyond the bare minimum. Because of the expected strong competition for licenses in New York, the Board will get to be selective about which companies get licenses, and it will want to pick cannabis companies that it feels confident will comply with the law. In addition, any company seeking to operate at the retail level will want to win the endorsement of its local government or community board as part of the licensing application process. Those governing bodies will want to endorse companies with strong compliance programs, ensuring that a company's operation within its borders does not foster an illicit market. Moreover, once in operation, cannabis companies will want to avoid costly investigations conducted by authorities, even if those investigations ultimately do not result in any penalties; the more robust the compliance program, the less likely regulators are to come knocking. Finally, for companies that envision going public, they will want a clean compliance record and a strong compliance program, so they are ready when the U.S. exchanges open up to them.

For these reasons, any company planning to enter the New York cannabis market should aim to be the gold standard in compliance. Investment in compliance now will be critical to long-term success in the New York market.

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Ballard Spahr LLP

THE NEW YORK LAW JOURNAL

Joint Defense: Steps Cannabis Companies Can Take Now to Protect Themselves Against Criminal Enforcement Actions in the New York Cannabis Market

October 25, 2021

By Michael P. Robotti and Shawn F. Summers

There are a number of compliance steps that cannabis companies can take now to minimize the chances of unlawful diversion from their companies.

Continued criminal enforcement in the New York cannabis market is a virtual certainty. There will be strong financial incentives built into the legal cannabis market to divert product to the illegal market; for some market participants, that potential gain will outweigh the risk of getting caught. Cannabis companies knowingly engaged in such diversion could face prosecution not only under state law, but also federal law, including both existing statutes and major proposed reform bills. To see how criminal anti-diversion enforcement is likely to play out in their market, cannabis companies need only look to similar, highly regulated markets, such as the pharmaceutical and tobacco industries. Authorities have brought criminal charges against companies, owners and employees that have knowingly failed to live up to their compliance obligations. With that experience as a guide, there are a number of compliance steps that cannabis companies can take now to minimize the chances of unlawful diversion from their companies.

Incentives for Diversion in the New York Cannabis Market

Once the legal cannabis market is operating in New York, the illicit market still is expected to continue functioning for years, with prices well below the legal market. See Will Yakowicz, “Why New York Legalizing Recreational Cannabis Won’t Kill the Illicit Market,” Forbes.com (March 19, 2021); “Assessment of the Potential Impact of Regulated Marijuana in New York State,” N.Y. Dep’t of Health (July 2018) (DOH Assessment), at 16-21. This price disparity is explained, at least in part, by taxes and regulatory costs. See id. New York has imposed substantial taxes on cannabis, and taxes will increase if cannabis is federally legalized. There are also significant regulatory costs in the legal market. For example, New York imposes strict requirements for testing and packaging of cannabis. Marijuana Regulation and Taxation Act (MRTA) §§81-82. These taxes and regulatory costs ultimately increase the prices that consumers pay. The illicit market has no such taxes or regulation to drive up prices, so participants in the illegal market can undercut the price of cannabis in the legal market.

There lies the temptation for unlawful diversion, which for some will overcome the risk associated with violating the law. To dodge taxes or regulatory costs that eat into profits—or simply to sell excess legal supply—some legal market participants will sell a portion of their product in the illegal market. Alternatively, in a scheme known as inversion, some may attempt to inject illegal cannabis into the legal market, fraudulently selling it as licensed cannabis and avoiding taxes and costs up the distribution chain. These are just some examples of the unlawful schemes likely to occur in New York. Cf. “Illicit Tobacco—Various Schemes are Used to Evade Taxes and Fees,” U.S. Government Accountability Office (March 2011) (GAO Report). And, some who do not directly participate in such schemes may be tempted to turn a blind eye to them if it increases their bottom line.

If cannabis is a legal substance in New York, why do authorities care about diversion? Well, to begin with, money. Part of the rationale for legalizing cannabis is the significant tax revenue expected from legal sales. See MRTA §2; DOH Assessment at 16-21. Because diverted cannabis is not taxed, diversion can lead to considerable lost tax revenue. Charged with protecting the public fisc, authorities will use the tools at their disposal, including criminal prosecution, to try to stamp out the illegal market. Authorities have also asserted other interests in preventing diversion, including preventing cannabis revenue from funding criminal organizations; keeping cannabis from minors; preventing violence and firearms use; and ensuring cannabis meets safety and quality standards. See MRTA §2; James M. Cole, “Guidance Regarding Marijuana Enforcement,” U.S. Dep’t of Justice (DOJ) (Aug. 29, 2013) (Cole Memo). The New York cannabis market is presently operating in a legal grey area, as its precise boundaries still must be defined through regulation and federal legalization still is pending. But once the market parameters are set, prosecutors will more aggressively seek to protect these governmental interests.

Criminal Anti-Diversion Enforcement in the New York Cannabis Market

Prosecutors will have a number of statutory tools available to them to combat diversion. The MRTA includes criminal penalties for diversion. Current federal law does too, as do major federal reform bills.

New York Law. The MRTA creates a comprehensive licensing scheme for New York’s legal market and contains broad prohibitions against diversion. The law specifically prohibits unlicensed distribution of cannabis, diversion of cannabis to unlicensed persons and aiding and abetting any such activity. MRTA §125. The licensee is responsible for ensuring that the licensed location conforms to the law’s requirements; licensees will be “held strictly accountable for any and all violations” that occur at the premises or by its employees. MRTA §125.8.

Any person who engages in unlicensed distribution of cannabis is subject to prosecution under N.Y. Penal Law §222. MRTA §132. That law provides for graduated criminal penalties for unlawful possession and distribution of cannabis. N.Y. Penal Law §§222.25-222.65. At the highest level, “aggravated criminal sale of cannabis” is a felony punishable by up to 15 years in prison. N.Y. Penal Law §§70.00(2)(c), 222.65. Thus, even following reform in New York, cannabis companies—as well as their owners and employees—still could face stiff penalties for illegal diversion.

Current Federal Law. The Controlled Substances Act (CSA) generally prohibits the knowing and intentional manufacture, distribution and possession of marijuana. See 21 U.S.C. §841. The CSA imposes severe penalties for violating its provisions. See id. But DOJ, as a matter of discretion, typically has not enforced that law against cannabis companies that comply with state law. In fact, in the August 2013 Cole Memo, DOJ enshrined that policy in a formal directive to federal prosecutors. See Cole Memo. Although DOJ rescinded that directive in 2018, it has remained influential with federal prosecutors. Additionally, since December 2014, Congress has annually passed the Rohrabacher-Farr Amendment, prohibiting DOJ from using federal funds to prosecute medical cannabis companies that comply with state law. See *United States v. Pisarski*, 965 F.3d 738, 741 (9th Cir. 2020). Importantly, though, neither the Cole Memo nor the Rohrabacher-Farr Amendment prohibit federal prosecution of cannabis companies that fail to comply with state law and engage in unlawful diversion. See id.; Cole Memo at 3-4. The federal government has continued to prosecute such conduct. See “The Controlled Substances Act (CSA): A Legal Overview for the 117th Congress,” Congressional Research Service (Feb. 5, 2021) (CRS Report), at 26-27.

Proposed Federal Changes. Major reform bills have not suggested eliminating federal criminal enforcement of cannabis laws. If these bills or similar versions become law, they will continue to arm prosecutors with strong weapons against unlawful diversion.

The "Marijuana 1-to-3 Act of 2021" is the least transformative of the bills, simply proposing to reschedule marijuana from Schedule I to Schedule III under the CSA. Such rescheduling would expand federally authorized distribution of marijuana. See 21 U.S.C. §§823, 829. But authorized distribution would remain subject to the CSA's anti-diversion requirements, and unauthorized distribution still would be subject to the CSA's present criminal penalties. 21 U.S.C. §§823, 841.

The "Marijuana Opportunity Reinvestment and Expungement Act of 2021" (MORE Act) is much more progressive. Yet, it still proposes criminal penalties for unlawful cannabis diversion, albeit far less severe penalties than the CSA. It creates a new federal licensing scheme for cannabis and removes cannabis from the CSA's purview. MORE Act §§3, 5(b) (adding §§5922 and 5923 to Internal Revenue Code). However, it also creates a new criminal scheme, whereby those distributing untaxed cannabis, with the intent to defraud the United States, face up to five years' imprisonment. Id. §5(b) (adding new §5942).

The "Cannabis Administration and Opportunity Act" (CAOA) likewise establishes a federal licensing scheme for certain cannabis businesses, and it retains criminal liability for diversion of 10 pounds or more of cannabis (but does not yet propose appropriate penalties). See CAOA Discussion Draft §§112, 511. It also proposes transferring primary DOJ jurisdiction over cannabis enforcement from the Drug Enforcement Administration (DEA) to the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF). See id. §102. It further creates a "federal track and trace regime" to prevent diversion and tax evasion, and it imposes affirmative reporting requirements on cannabis companies to notify DOJ if they have knowledge of diversion or tax evasion. Id. §112(b). Thus, CAOA and other major reform bills lay the ground work for continued federal criminal enforcement in the New York cannabis market.

Criminal Anti-Diversion Enforcement in Similar Markets

To see how criminal enforcement may play out in New York's cannabis market, it is useful to compare such enforcement in the pharmaceutical and tobacco industries, which also face stringent anti-diversion requirements. Participants in both industries have faced criminal prosecution for unlawful diversion.

The pharmaceutical industry, in particular, has faced significant scrutiny over the unlawful diversion of opioids. Opioids are subject to the CSA's anti-diversion requirements, which require pharmaceutical companies to maintain effective controls against diversion, and a company's knowing failure to meet those requirements can lead to prosecution under the CSA's drug trafficking provisions. See 21 U.S.C. §§823, 841. The CSA also imposes affirmative reporting requirements for potential diversion. See id. §832. Additionally, the DEA has created a national database, known as "ARCOS," to track certain controlled substances through the supply chain. Despite these anti-diversion requirements and safeguards, numerous doctors and pharmacists have faced prosecution for knowingly engaging in unlawful diversion of opioids. See CRS Report at 16-20. More recently, DOJ has prosecuted distributors for knowingly failing to implement adequate protocols to prevent such downstream diversion. In April 2019, DOJ brought criminal charges against Rochester Drug Co-Operative, a major distributor, and two of its executives for distributing to pharmacies that illegally diverted opioids. See "Manhattan U.S. Attorney and DEA Announce Charges Against Rochester Drug Co-Operative and Two Executives for Unlawfully Distributing Controlled Substances," DOJ (April 23, 2019). Later that year, DOJ brought charges against another opioid distributor, Miami-Luken, Inc., as well as two of its employees and two customer pharmacists, for similar conduct. See "Pharmaceutical Distributor & Executives, Pharmacists Charged with Unlawfully Distributing Painkillers," DOJ (July 18, 2019). Among the compliance failures DOJ cited in bringing charges were the companies' knowing distribution of opioids to their customer pharmacies, despite red flags of diversion, and their failure to report customers' suspected diversion to the DEA.

The ATF, which regulates the tobacco industry, has likewise worked with federal prosecutors to bring criminal charges against companies and persons engaged in unlawful diversion in the cigarette market. See GAO Report at 5, 19-22; "Fact Sheet—Tobacco Enforcement," ATF (May 2018). The ATF has particularly focused on preventing the diversion of cigarettes to avoid the payment of taxes and the distribution of counterfeit cigarettes. See id. Thus, despite broad availability of legal cigarettes, federal authorities have continued to use criminal prosecution to prevent diversion.

Compliance Best Practices

Cannabis companies should expect that criminal enforcement will grow more prevalent in the New York market over time. With the above discussion in mind, there are several compliance measures they can put in place to minimize the chances of unlawful diversion. These best practices include: (1) written compliance policies and procedures, including written anti-diversion protocols; (2) employee training on those policies and procedures; (3) a dedicated compliance department, independent of the company's sales personnel to avoid conflicts of interest; (4) know-your-customer (KYC) diligence procedures, including site visits, a customer application process and an upfront review of pertinent customer documents, such as licenses, customer lists, order history and anti-diversion protocols; (5) processes to monitor customer orders for red flags of diversion; and (6) mechanisms for quickly and fully reporting suspected diversion to authorities. By taking these steps, cannabis companies will be instituting robust compliance procedures that will reduce the chances of unlawful diversion from their companies, as well as the accompanying costly investigations and criminal penalties.

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BUSINESS CRIMES BULLETIN

Smoke & Mirrors: The New York Cannabis Law's Illusory Lease Mandate

November 2021

By Marjorie J. Peerce, Michael P. Robotti, and Kamera Boyd

New York's recently enacted cannabis law, the Marijuana Regulation and Taxation of 2021 (MRTA), created a maze of new legal requirements. These provisions affect not only cannabis companies, but also the companies that conduct business with them. Navigating this maze can be tricky, especially since much of the MRTA conflicts with federal law. One particularly complex area is the regulation of New York real estate as it relates to cannabis companies. Cannabis companies and landowners alike should be wary of the legal pitfalls in this area and seek appropriate legal guidance.

Under the MRTA, New York will grant licenses to companies to distribute cannabis. Although these companies will be state-licensed, it likely will violate the federal "stash-house law" to lease property to them. Landowners may be reluctant to lease to licensed cannabis businesses and risk federal criminal liability, when they could lease to other types of businesses without that risk. This landowner reluctance could create a Catch-22 for cannabis companies: to get a state license, they need property from which to operate their cannabis business; but to get property, under federal law, they cannot plan to sell cannabis from it.

The MRTA contains a provision that seems like it could help cannabis companies with reluctant landowners; specifically, it has a lease mandate, which prevents landowners from discriminating against at least some participants in the legal cannabis market. Precisely who the lease mandate protects, though, is subject to debate. While it could be read to prevent landowner discrimination against cannabis consumers *and* cannabis companies — as opposed to just cannabis consumers — such an interpretation likely would result in federal preemption of the mandate. To avoid preemption, courts likely will interpret the mandate narrowly, prohibiting discrimination only against cannabis consumers. So, cannabis companies should not put too much stock in this mandate when attempting to secure a property.

Cannabis Licenses Are Tied to Property

The MRTA creates a licensing scheme for the legal cannabis market, requiring businesses operating at each supply chain level to obtain licenses. *See*, "What is in the Law – Adult-Use License Types," cannabis.ny.gov. It confers authority on the Office of Cannabis Management Control Board (Board) to grant licenses. Typically, an applicant must have an appropriate premises from which to operate before getting a license. *See*, MRTA §§61, 64.1(e), 126. For instance, the law requires that a license set forth a description of the licensed premises, and it specifies that each facility generally must have a separate license. *See*, *id*. §61. The Board will evaluate whether an applicant "possesses or has the right to use sufficient land, buildings, and equipment to properly conduct a cannabis business" or, if applying under the law's social and economic equity provisions, "has a plan to do so." *Id*. §64. And, for retail and on-site use dispensaries, they must be located in a storefront with a street-level entrance. *Id*. §72.5. To get a license, then, securing an appropriate premises will be necessary.

The Federal Stash-House Law

The federal stash-house law complicates these real estate requirements. That law makes it unlawful for a landowner to knowingly and intentionally "rent, lease, profit from, or make available for use" a location for the purpose of "unlawfully manufacturing, storing, distributing, or using a controlled substance." 21 U.S.C. §856(a)(2). Because marijuana remains a controlled substance under federal law, *see, id*. §841, this statute likely will apply to any landowner who leases a premises to a cannabis business for these purposes. Violators face up to 20 years' imprisonment, substantial fines, and criminal forfeiture of their property. *Id*. §§856(b), 881(a)(7). In recent years, the Department of Justice (DOJ), as a matter of discretion, usually has not enforced this law against landowners leasing property to state-licensed cannabis businesses. Yet, it remains a federal crime to do so.

New York's Lease Mandate

Due to the federal stash-house law, some landowners may be hesitant to lease to New York's licensed cannabis businesses. Just as many financial institutions have declined to provide services to state-licensed cannabis businesses, *see*, Beth Moskow-Schnoll & Shawn F. Summers, "Buzzkill: The AML Implications of Banking Marijuana-Related Businesses," 36 Rev. Banking & Fin. Servs. 109, 109-10 (Sept. 2020), some landowners may be equally wary about exposing themselves to federal criminal liability — even if DOJ has elected not to prosecute landowners and cannabis companies who comply with state law in recent years, *see, id*. at 111-16. The MRTA's broad anti-discrimination provisions, however, may help cannabis companies with this landowner reluctance; they include a lease mandate, prohibiting landowner discrimination against at least some legal market participants. But just how broad is this mandate?

Section 127 of the MRTA states in pertinent part:

Protections for the use of cannabis; unlawful discriminations prohibited.

1. No person, registered organization, licensee or permit-tee, employees, or their agents shall be…denied any right or privilege…solely for conduct permitted under [the MRTA].

…

2. *No landlord may refuse to lease to and may not otherwise penalize an individual solely for conduct authorized under [the MRTA], except:*

   (a) if failing to do so would cause the landlord to lose a monetary or licensing related benefit under federal law or regulations….

MRTA §127 (emphasis added).

Based on its plain language, there is an argument that the lease mandate is quite narrow. It prohibits a landlord from refusing to lease to "an individual," a statutory term that arguably does not include companies. *See, e.g., Nguyen Thang Loi v. Dow Chem. Co.*, 373 F. Supp. 2d 7, 56 (E.D.N.Y. 2005) ("[T]he plain meaning of the term 'individual' does not ordinarily include a corporation.") (citations omitted). The MRTA does not specifically define the term "individual"; by comparison, "person" is defined to include "an individual" and certain legal entities, suggesting that "an individual" means a natural person as opposed to such entities, like cannabis companies. MRTA §3.1. In addition, the mandate's use of the word "individual" is notable, as compared to the broader list of terms that encompasses legal entities in the general anti-discrimination provision in preceding paragraph. The more limited word choice suggests that the lease mandate has a narrower application. Thus, based on the mandate's use of the term "individual," there is an argument that it is intended to prevent discrimination against only cannabis consumers entering residential leases — an argument reinforced by the portion of the section title "protections for the use of cannabis." *Id.*

Indeed, several other states that have enacted lease mandates as part of their medical cannabis laws have limited their applicability to patients, suggesting that the New York law might have a similar meaning. *See, e.g.*, Ariz. Rev. Stat. §36-2813 ("No school or landlord may refuse to enroll or lease to and may not otherwise penalize a person solely for his status as a cardholder …."); Del. Code Ann. tit. 16, §4905A(a)(1) ("No school or landlord may refuse to enroll or lease to, or otherwise penalize, a person solely for his or her status as a registered qualifying patient or a registered designated caregiver …."); Haw. Rev. Stat. §329-125.5(similar).

Conversely, there is an argument that this lease mandate is quite broad. On its face, it is not explicitly limited to cannabis consumers seeking to enter residential leases. It draws no distinction between such individuals and individuals, like cannabis company owners, who sign commercial leases or serve as personal guarantors. And, the MRTA specifically authorizes the Board to grant cannabis business licenses to "an individual or an entity," meaning that "individual" licensees will be entering commercial leases, in addition to company representatives. MRTA §3.31; *see, id.* §62.3. Moreover, the mandate explicitly prohibits landowner discrimination against all conduct authorized under the MRTA, which includes cultivating, processing, distributing and selling, not just personal use. Certainly, a landlord's denial of a commercial lease to an individual seeking to operate a cannabis company at that location would "penalize" that individual for legal conduct under the MRTA. In addition, had the legislature, in fact, meant to limit the mandate's protections to cannabis consumers, it knew how to craft such limited language. As noted above, the legislature had clear examples from other states. Additionally, in the MRTA, when the legislature intended to specify a cannabis consumer or personal use, it specifically did so. *See, e.g.*, MRTA §3.6 (defining "cannabis consumer"); *id.* §125.11 (prohibiting house-to-house cannabis sales "at residence or place of business of a cannabis consumer"); §127.6 (noting limited circumstances parole and probation authorities may prohibit "person's cannabis use").

Finally, the lease mandate must be informed by the general anti-discrimination provision in the preceding paragraph, as well as the portion of the section title "unlawful discriminations prohibited." That provision prohibits any "person, registered organization, licensee or permit-tee, employees, or their agents" from being "denied any right or privilege … solely for conduct permitted under [the MRTA]." The provision's breadth signifies a legislative intent to prohibit all discrimination against all legal market participants, suggesting the lease mandate likewise should be read to confer broad protections. *Cf. Green Cross Med., Inc. v. Gally*, 242 Ariz. 293, 298 (Ariz. Ct. App. 2017) (construing provision prohibiting denial of "any right or privilege … by a court" to protect "rights of dispensaries to enter into leases and contracts" that comply with state law (emphasis omitted)). Accordingly, the lease mandate is subject to two very different interpretations.

Like the mandate itself, the first exception to it is somewhat ambiguous. The mandate does not apply if it would cause a landowner to lose a "monetary or licensing related benefit." The law does not explain what qualifies as such a benefit. One question is whether potential federal criminal penalties, like fines and forfeiture, would qualify as loss of a "monetary benefit." That interpretation, though, may stretch the term's meaning, which more logically means a loss of federal grants or subsidies. Further, as discussed above, any landowner who leases to a cannabis business likely violates the federal stash-house law. Thus, if the law exempted any landowner subject to federal criminal penalties from the mandate, the exception would largely swallow the rule, rendering it meaningless in many circumstances.

Ultimately, it will be up to the courts to interpret the mandate. The federal stash-house law necessarily will inform this interpretation. Indeed, to save it from federal preemption, courts may need to select the narrower interpretation of the mandate.

The Stash-House Law May Preempt the Lease Mandate

If New York's lease mandate is broadly interpreted, the federal stash-house law likely preempts it. The Supremacy Clause makes federal law supreme. *See*, U.S. Const. art. VI, cl. 2. "Under the doctrine of federal preemption, 'state laws that conflict with federal law are without effect.'" *Mary Jo C. v. N.Y. State & Local Ret. Sys*., 707 F.3d 144, 161 (2d Cir. 2013). Where a statute does not contain an express preemption provision (which the stash-house law does not), courts have recognized implied "conflict preemption," if "state law 'actually conflicts with federal law.'" *Id*. An actual conflict exists "'when compliance with both federal and state regulations is a physical impossibility'" or, put differently, "where federal law is in 'irreconcilable conflict' with state law." *Id*. There is a presumption against preemption; "if there is any ambiguity as to whether the local and federal laws can coexist," courts will uphold the law. U.*S. Smokeless Tobacco Mfg. Co. LLC v. City of New York*, 708 F.3d 428, 433 (2d Cir. 2013).

Insofar as it prevents landowners from discriminating against cannabis businesses, the lease mandate is likely preempted by the federal stash-house law. If landowners comply with the state mandate and lease their properties to cannabis businesses, they will violate federal law. So interpreted, these laws irreconcilably conflict. Notably, this conflict is different in kind from many other MRTA provisions, which *permit* cannabis companies and consumers to engage in federally illegal activity. While those provisions undoubtedly conflict with federal law, they do not *require* any person or entity to violate it. By contrast, the lease mandate creates a more pronounced conflict by requiring landowners to engage in federally illegal conduct, potentially over their objections. It thus is a "physical impossibility" for landowners to follow both New York and federal law, which creates an actual conflict under federal preemption law.

Other states have largely avoided creating such conflicts with federal law. Some states allow landowners to prohibit cannabis distribution. *See, e.g.*, Durango, Co. Code of Ordinances §13-166("[P]roof of possession shall include a signed statement from the landlord or owner of the premises consenting to the use of the property for the purposes of operating a retail marijuana establishment."); Ann. L. Mass. Ch. 94D §2(d)(1) (landlord may prohibit or regulate cannabis "consumption, display, production, processing, manufacture or sale"); Vt. Stat. Ann. Tit. 18, §4230a(b)(E)(landlord may ban "possession or use of cannabis in lease agreement"); *see also, Green Cross Med., Inc.*, 242 Ariz. at 298 (declining to void dispensary lease as illegal under federal law, in part, because Arizona law did not require landowner to enter lease). Others, as noted above, have limited anti-discrimination provisions to cannabis consumers. *See, e.g.*, Ariz. Rev. Stat. §36-2813; Del. Code Ann. tit. 16, §4905A(a)(1); Haw. Rev. Stat. §329-125.5. New York's mandate appears to go beyond these laws.

To save the law from preemption, courts may be required to interpret it narrowly to prohibit landowner discrimination only against cannabis consumers entering residential leases. *See*, MRTA §2 ("Nothing in this act is intended … to require any individual to engage in any conduct that violates federal law …."). Landowners leasing to such individuals are likely beyond reach of the federal stash-house law. *See, United States v. Shetler*, 665 F.3d 1150, 1162 (9th Cir. 2011) (holding "incidental" personal drug use at residential premises beyond scope of stash-house law). Alternatively, courts could broadly interpret the first exception to the mandate to exempt any landowner subject to federal criminal exposure. That interpretation would effectively limit the mandate to cannabis consumers. Either way, though, to avoid federal preemption, the MRTA likely cannot require a landowner to lease to a cannabis business that intends to use a property to distribute cannabis. Such a requirement puts landowners in an unconstitutional bind, requiring them to choose between following New York or federal law.

Practical Considerations

What does this mean practically? For cannabis companies, it means that they should not blithely assume that they will be able to secure property easily, considering the legal uncertainty surrounding New York's lease mandate. Reluctant landowners may turn down such lease applications and, if a cannabis company invokes the lease mandate in response, the landowners may litigate, seeking to have it struck down. Cannabis companies should permit themselves ample time in advance of submitting their license applications to the Board to find the required property. It may take time to locate a willing landowner or to litigate with a reluctant landowner in advance of the application deadline.

This new law, which has ushered in a new post-prohibition era in New York, poses significant issues for cannabis companies and landowners alike. Proceeding with caution and seeking appropriate advice before embarking on such ventures is critical.

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The views expressed in the article are those of the authors and not necessarily the views of their clients or other attorneys in their firm.

THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

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BUZZKILL: THE AML IMPLICATIONS OF BANKING MARIJUANA-RELATED BUSINESSES

Despite FinCEN's onerous requirements and the risks involved, in recent years a growing number of financial institutions have been willing to do business with MRBs. The authors discuss the unique legal and compliance risks associated with providing financial services to the marijuana industry and recommend specific controls to mitigate the identified risks.

By Beth Moskow-Schnoll and Shawn F. Summers *

Federal law prohibits the manufacture, distribution, and possession of marijuana and financial transactions associated with such activities. Nonetheless, 34 states, as well as the District of Columbia, Guam, and Puerto Rico, have legalized the sale of marijuana to some degree,[1] and overall sales of legal cannabis within the U.S. reached $10.3 billion by the end of 2018 and are expected to reach $17 billion by the end of 2020.[2] Despite this state-level move toward legalization and the vast size of the market, most financial institutions remain reluctant to conduct transactions involving marijuana proceeds or marijuana-related businesses ("MRBs"), although that too is changing. This article discusses the unique legal and compliance risks associated with providing financial services to the marijuana industry and recommends specific controls to mitigate the identified risks.

CANNABIS

Constraints Imposed by Federal Law

Despite the decisions of many states to legalize the growth, possession, and distribution of marijuana for medical and/or recreational purposes, dealing in marijuana — including for medical purposes recognized as legitimate under state law — remains a federal crime. As explained below, the federal prohibition against possessing and distributing marijuana presents a particular problem to financial institutions seeking to

[1] Eleven states and the District of Columbia have legalized adult recreational use of marijuana, while 23 states have comprehensive medical marijuana programs only. With the adult-use states, there are a total of 34 states with medical marijuana programs. *See Where is Cannabis Legal?,* LEAFLY (Jan. 17, 2020), https://www.leafly.com/news/cannabis-101/where-is-cannabis-legal.

[2] *See* Chris Hudock, *U.S. Legal Cannabis Market Growth,* NEW FRONTIER DATA (Sept. 8, 2019), https://newfrontierdata.com/cannabis-insights/u-s-legal-cannabis-market-growth/.

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offer services to MRBs. Specifically, the mere act by a state-sanctioned MRB of depositing the proceeds of its marijuana sales into a bank account could constitute a federal offense.

Federal Drug Laws: Marijuana remains a Schedule I controlled narcotic under the federal Controlled Substances Act ("CSA"), which means that the federal Food and Drug Administration has determined that marijuana has no currently accepted medical use. As such, it is a federal felony to knowingly manufacture, distribute, dispense, or possess marijuana.[3] Likewise, it is a federal felony to attempt, or to conspire to commit, such offenses, or to aid and abet others in committing such offenses.[4] In general, these offenses can result in potentially severe prison sentences, and even can produce statutory mandatory minimum sentences of five, 10, or 20 years in cases involving large drug amounts and/or prior felony drug convictions.[5]

In 2016, the U.S. Drug Enforcement Agency ("DEA") reiterated that, in the eyes of the federal government, marijuana remains a Schedule I controlled substance.[6] Recent federal legislative efforts to reschedule marijuana or enshrine protections for state legalization — such as the Marijuana Opportunity Reinvestment and Expungement ("MORE") Act,[7] the Sensible Enforcement of Cannabis Act,[8] and the Regulate Marijuana Like Alcohol Act[9] — have gained momentum since the Democratic takeover of the House of Representatives in 2019, but none has yet been successful.[10] The furthest advanced legislation, the Secure And Fair Enforcement ("SAFE") Banking Act,[11] has essentially been passed twice by the House,[12] but would not deschedule marijuana even if it became law. Thus, states that allow marijuana for medical use or which legalize recreational use do so in defiance of federal law.

Money Laundering: Very generally, the federal offense of money laundering involves a financial transaction conducted with the proceeds of a "specified unlawful activity" ("SUA"), while knowing that the proceeds were earned through illegal activity.[13] The list of SUAs identified by Congress is specific but also extremely long (over 200 separate crimes).[14] Drug

[3] 21 U.S.C. §§ 841, 844.

[4] 21 U.S.C. § 846; 18 U.S.C. § 2.

[5] 21 U.S.C. § 841(b).

[6] Denial of Petition to Initiate Proceedings to Reschedule Marijuana, 81 Fed. Reg. 53687 (Aug. 12, 2016).

[7] H.R. 3884, 116th Cong. (2019). Among other provisions, the MORE Act would decriminalize and deschedule marijuana entirely. *See id.* § 2(a).

[8] H.R. 493, 116th Cong. (2019). The Sensible Enforcement of Cannabis Act does not deschedule marijuana, but it explicitly prohibits the Attorney General from prosecuting violations of the CSA involving state-legal marijuana. *Id. § 2(a).*

[9] H.R. 420, 116th Cong. (2019). The Regulate Marijuana Like Alcohol Act would deschedule marijuana. *See id.* § 201. The resolution number is intentional. *See* Tom Angell, *New Congressional Marijuana Bill Is Actually Numbered H.R. 420*,

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Forbes (Jan. 9, 2019), https://www.forbes.com/sites/tomangell/2019/01/09/new-congressional-marijuana-bill-is-actually-numbered-h-r-420/#47dc33172e60 ("In a hat tip to marijuana cultures, lawmakers on Capitol Hill have officially reserved the number H.R. 420 for a bill that would dramatically change federal cannabis laws.").

[10] For example, the MORE Act now has 74 cosponsors in the House, including one Republican. *Cosponsors - H.R.3884 - 116th Congress (2019-2020): Marijuana Opportunity Reinvestment and Expungement Act of 2019*, CONGRESS.GOV, https://www.congress.gov/bill/116th-congress/house-bill/3884/cosponsors (last accessed June 18, 2020).

[11] H.R. 1595, 116th Cong. (2019).

[12] The House passed the SAFE Banking Act in September 2019 with a resounding 321-103 vote, but it has not been taken up by the Senate. *See* Sean Williams, *Surprise! There's Cannabis Reform Legislation in the Latest COVID-19 Relief Bill*, THE MOTLEY FOOL (May 17, 2020), https://www.fool.com/investing/2020/05/17/surprise-theres-cannabis-reform-legislation-in-the.aspx. Subsequently, the House included the full text of the SAFE Banking Act in the HEROES Act, the pandemic relief bill it passed in May 2020, but commentators believe the SAFE Banking Act has little chance of staying in the law to final passage, even if the Senate did decide to take up the HEROES Act. *Id.*

[13] 18 U.S.C. §§ 1956 and 1957.

[14] *Id.* § 1956(c)(7).

distribution, including the distribution of marijuana, is an SUA.[15] The money laundering statutes criminalize a financial transaction using proceeds earned through an SUA.[16] A "transaction" can be very simple, and includes any bank deposit, withdrawal, or wire.[17]

In addition, Section 1956 generally requires a defendant to act with one of four possible intents: (1) an intent to conceal or disguise the nature, location, source, ownership or control of the SUA proceeds; (2) to promote the underlying SUA (here, the distribution of marijuana); (3) to avoid a transaction reporting requirement under federal law, such as the filing of a Suspicious Activity Report ("SAR") or a Currency Transaction Report ("CTR"); or (4) to commit the offense of tax evasion or filing a false tax return.[18] In the context of a financial institution providing banking services to MRBs, some of these prohibited mental states could be at issue.

Section 1957 — the so-called "spending" money laundering statute — also presents risk. Section 1957 is very broad. It merely requires a transaction involving over $10,000 in SUA funds and knowledge that the proceeds were derived from criminal activity.[19] None of the special intents previously described under Section 1956 are required; there is no need for an intent to conceal or further the underlying offense.[20] Moreover, the $10,000 threshold is triggered either by one transaction of more than $10,000 or by aggregated, related transactions, such as four related financial transactions conducted over time, each involving $3,000 in SUA funds.[21] Otherwise mundane financial transactions done with complete transparency can represent Section 1957 violations, so long as there is sufficient knowledge and the financial transactions involve over $10,000 in SUA funds.

Forfeiture: Beyond a potential criminal prosecution, the proceeds of a money laundering transaction or a controlled drug transaction can be forfeited. This complicated topic will be merely noted here. The bottom line is that the federal government can institute a separate civil forfeiture action against tainted property, or a criminal forfeiture action linked with a specific prosecution of an individual or institution, and thereby seize and obtain any and all proceeds "involved in" or "traceable to" a money laundering or drug transaction.[22] The burden of proof for a civil forfeiture action is merely a preponderance of the evidence, and the government is not obligated to actually convict anyone of a crime in order to prevail under a civil forfeiture theory. A civil forfeiture action can be brought against SUA funds held by a third party, subject to very limited defenses by the third party.

Limited Federal Policy of Prosecutorial Restraint

Even in the absence of new federal laws restraining marijuana enforcement like the SAFE Banking Act and the Sensible Enforcement of Cannabis Act, the U.S. Department of Justice and Congress have placed certain limits on the federal investigation and prosecution of cases involving marijuana-related activity that strictly complies with state law. However, and as described below, these limits merely represent policies of restraint on enforcement decisions — they do not guarantee any particular outcomes in specific cases, they do not legalize conduct that is unlawful under the CSA or the money laundering statutes, and they are not necessarily permanent.

DOJ Policy: In August 2013, James M. Cole, the then-Deputy Attorney General, issued new guidance (the "Cole Memo") regarding marijuana enforcement in states that had passed some form of marijuana reform legislation.[23] The Cole Memo concluded that threats to federal priorities under the CSA are allayed in jurisdictions that have strong and effective regulatory and enforcement systems to control marijuana growth and distribution.[24] Nonetheless, the Cole Memo reiterated DOJ's commitment to enforcing the CSA as it relates to marijuana involved offenses.[25]

To aid in effectively enforcing the CSA, the Cole Memo laid out the following enforcement priorities (the

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[15] *Id.* § 1956(c)(7)(B)(i).

[16] *Id.* § 1956(a)(1).

[17] *Id.* § 1956(c)(3).

[18] *Id.* § 1956(a)(1).

[19] *Id.* § 1957(a).

[20] *See, e.g., United States v. Cefaratti*, 221 F.3d 502, 506 (3d Cir. 2000).

[21] *See, e.g., United States v. George*, 363 F.3d 666, 674–75 (7th Cir. 2004).

[22] 18 U.S.C. §§ 981–983; 21 U.S.C. § 853.

[23] James M. Cole, *Guidance Regarding Marijuana Enforcement*, U.S. DEPARTMENT OF JUSTICE (Aug. 29, 2013), https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.

[24] *Id.* at 3.

[25] *Id.* at 1.

"Cole Memo Priorities") which are intended to inform decisions by federal prosecutors to investigate and prosecute marijuana-related cases: (1) "[p]reventing the distribution of marijuana to minors;" (2) "[p]reventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;" (3) "[p]reventing the diversion of marijuana from states where it is legal under state law in some form to other states;" (4) "[p]reventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;" (5) "[p]reventing violence and the use of firearms in the cultivation and distribution of marijuana;" (6) "[p]reventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;" (7) "[p]reventing the growing of marijuana on public lands, and the attendant public safety and environmental dangers posed by marijuana production on public lands;" and (8) "[p]reventing marijuana possession or use on federal property."[26] Ultimately, the Cole Memo gave federal prosecutors in states that had legalized the growing and distribution of marijuana wide discretion to assess on a case-by-case basis the extent to which a particular marijuana growth and distribution enterprise undermined the stated enforcement priorities and was therefore worthy of prosecution.[27]

The Cole Memo represented merely a policy of endowing federal prosecutors with additional discretion regarding potential charging decisions; it did not legalize under federal law marijuana-related conduct sanctioned by state law, nor did it provide any guarantees or rights regarding particular outcomes in specific cases.[28] Yet, in the years following the issuance of the Cole Memo, DOJ and other federal agencies have largely been hands-off with state marijuana-related activities so long as those activities were in compliance with the eight enforcement priorities.

Perhaps what is even more remarkable is that DOJ's forbearance has largely continued even after then-Attorney General Jeff Sessions rescinded the Cole Memo in January 2018, stating in a one-page memo of his own that "prosecutors should follow the well-established principles that govern all federal prosecutions."[29] But as it turned out, Sessions had only 10 months left as Attorney General.[30] His successor, William Barr, has consistently expressed little interest in prosecuting state-legal marijuana activities,[31] even going so far as to state publicly in April 2020 that DOJ is "operating under my general guidance that I'm accepting the Cole Memorandum for now, but I've generally left it up to the U.S. Attorneys in each state to determine what the best approach is," as if the Cole Memo had never been rescinded.[32]

[26] *Id.* at 1–2.

[27] *Id.* at 3–4.

[28] The Cole Memo substantially tracks the analysis laid out in an earlier DOJ memorandum regarding cases involving medical marijuana. *See* David W. Ogden, *Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana*, U.S. DEPARTMENT OF JUSTICE (Oct. 19, 2009), https://www.justice.gov/sites/default/files/opa/legacy/2009/10/19/medical-marijuana.pdf (the "Ogden Memo"). The Ogden Memo stated in part that "[t]his guidance regarding resource allocation does not 'legalize' marijuana or provide a legal defense to a violation of federal law, nor is it intended to create any privileges, benefits, or rights, substantive or procedural, enforceable by any individual, party or witness in any administrative, civil or criminal matter. Nor does clear and unambiguous compliance with state law . . . create a legal defense to a violation of the Controlled Substance Act. Rather, this memorandum is intended solely as a guide to the exercise of investigative and prosecutorial discretion."

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The Ogden Memo was withdrawn by Attorney General Jeff Sessions in January 2018. *See* Jefferson B. Sessions, *Marijuana Enforcement*, U.S. DEPARTMENT OF JUSTICE (Jan. 4, 2018), https://www.justice.gov/opa/press-release/file/1022196/download.

[29] *Id.*

[30] Peter Baker, Katie Benner, and Michael D. Shear, *Jeff Sessions Is Forced Out as Attorney General as Trump Installs Loyalist*, N.Y. TIMES (Nov. 7, 2018), https://www.nytimes.com/2018/11/07/us/politics/sessions-resigns.html.

[31] Tom Angell, *Trump Attorney General Pick Puts Marijuana Enforcement Pledge in Writing*, FORBES (Jan. 28, 2019), https://www.forbes.com/sites/tomangell/2019/01/28/trump-attorney-general-pick-puts-marijuana-enforcement-pledge-in-writing/#6600eb1a5435. On the other hand, DOJ sources have claimed that it was Attorney General Barr's personal distaste for the marijuana industry, and not any bona fide antitrust concern, that was behind the Department's decision to impose painstaking reviews on several marijuana business mergers during his tenure, causing at least one deal to collapse as a result. *See Prosecutor: AG Barr Ordered Politically Motivated Probes of Cannabis Mergers*, MARIJUANA BUSINESS DAILY (June 23, 2020), https://mjbizdaily.com/allegation-attorney-general-william-barr-ordered-politically-motivated-probes-of-cannabis-mergers/.

[32] Jeff Smith, *Attorney General Barr: US Law Protecting State-Legal Marijuana Trumps Current Situation*, MARIJUANA

Therefore, although there is no guarantee that state-sanctioned marijuana-related activity that strictly complies with the Cole Memo Priorities will not be prosecuted — and there have been some exceptions involving zealous U.S. Attorneys[33] — history dictates that such activity is relatively low risk. Note, however, that this DOJ policy of discretion could change or end at any time.

Congressional Limits on Enforcement Spending — the Rohrabacher Amendment.[34] Despite the as-yet failure of permanent legislative fixes, state-legal MRBs do not depend entirely on DOJ's sufferance under the Cole Memo or otherwise. In December 2014, Congress enacted an Omnibus Appropriations Bill funding the government through September 2015.[35] This bill contained, tucked away in section 538, the "Rohrabacher Amendment" stating that no funds made available to DOJ by the bill could be used to prevent certain named states from implementing their own state laws that authorize the use, distribution, possession, or cultivation of medical marijuana.[36] In short, the amendment protects state-legal medical marijuana programs from federal interference. Because of its form as a rider on the annual appropriations bill, the Rohrabacher Amendment must be renewed on a yearly basis. So far, it has been reauthorized every year since its introduction. The amendment was most recently renewed in December 2019, through the 2020 fiscal year ending September 30, 2020.[37] Since 2017, President Trump has regularly inserted signing statements that he would treat the Rohrabacher Amendment "consistent with the President's constitutional responsibility to faithfully execute the laws of the United States," but has done nothing to interfere with its application.[38]

Federal courts have mainly upheld the amendment's protective purpose as its drafters understood it — that is, to strip DOJ's authority to spend its resources to prosecute medical marijuana-related offenses *if* the conduct was in full compliance with the state's own law regulating such conduct and there is no other illegal conduct alleged. In August 2016, the Court of Appeals for the Ninth Circuit, in the *McIntosh* case, held that the Rohrabacher Amendment "prohibits DOJ from spending funds from relevant appropriations acts for the prosecution of individuals who engaged in conduct permitted by the State Medical Marijuana Laws and who fully complied with such laws."[39] District courts within the Ninth Circuit have of course followed suit, as have courts elsewhere.[40]

Although the *McIntosh* case seemingly hampers or prohibits outright DOJ's ability to prosecute growers and dispensaries who are in strict compliance with their respective state statutes regarding medical marijuana, the

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BUSINESS DAILY (Apr. 10, 2019), https://mjbizdaily.com/attorney-general-william-barr-federal-law-protecting-state-legal-marijuana-trumps-current-situation/.

[33] *See, e.g.*, Ryan Boldrey, *Owner of Five Michigan Marijuana Dispensaries Headed to Federal Prison*, MLIVE (Aug. 26, 2019), https://www.mlive.com/news/grand-rapids/2019/08/owner-of-five-michigan-marijuana-dispensaries-sentenced-to-federal-prison.html (describing how the owner of an ostensibly state-legal marijuana business was tried and convicted under the CSA in federal court after being acquitted in state court for violations of state law).

[34] The Rohrabacher Amendment is also referred to as the "Rohrabacher-Farr Amendment" and, most recently, the "Rohrabacher-Blumenauer Amendment."

[35] Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, 128 Stat. 2129.

[36] *Id.* § 538, 128 Stat. at 2217.

[37] Consolidated Appropriations Act, 2020, Pub. L. No. 116-93, § 531, 133 Stat. 2317, 2530 (2019).

[38] Tom Angell, *Trump Says He Can Ignore Medical Marijuana Protections Passed By Congress*, FORBES (Dec. 21, 2019), https://www.forbes.com/sites/tomangell/2019/12/21/trump-says-he-can-ignore-medical-marijuana-protections-passed-by-congress/#2720442a4256.

[39] *United States v. McIntosh*, 833 F.3d 1163, 1177 (9th Cir. 2016).

[40] *United States v. Jackson*, 388 F. Supp. 3d 505, 512–13 (E.D. Pa. 2019) (finding that, under *McIntosh*, DOJ could not punish violations of supervised release conditions involving Pennsylvania-legal medical marijuana); *United States v. Samp*, No. 16-cr-20263, 2017 U.S. Dist. LEXIS 46291, at *4 (E.D. Mich. Mar. 29, 2017) (holding that the Rohrabacher Amendment would forbid charging a state-legal marijuana business owner with firearms offenses for otherwise lawfully possessed firearms because it would have "materially the same effect" as prosecuting him for owning a state-legal marijuana business directly); *United States v. Moore*, 274 F. Supp. 3d 1032, 1040 (N.D. Cal. 2017) (finding that defendants had proven "their strict compliance with all relevant conditions imposed by California law on the use, distribution, possession, and cultivation of medical marijuana" and therefore enjoining the prosecution against them); *but see United States v. Ragland*, No. 2:15-cr-20800, 2017 U.S. Dist. LEXIS 97852, at *7 (E.D. Mich. June 26, 2017) (distinguishing *McIntosh* and *Samp* and allowing the Government to pursue claims where the charges allege illegal conduct apart from the element of marijuana use).

court still rejected the defendants' argument that the prosecution of marijuana-related offenses should be left solely to the states and sternly warned that the CSA is still in effect, federal law remains supreme, and "Congress could restore funding tomorrow."[41] Indeed, the case did not change the fact that the manufacture, possession, use, and distribution of marijuana violate the CSA. Thus, any inability to prosecute flows solely from the continued viability of the Rohrabacher Amendment. Further, marijuana sale proceeds continue to constitute SUA proceeds under the money laundering statutes.[42]

MRBs' Access to the Banking and Financial System

Financial institutions, such as banks and credit unions, are required to implement adequate anti-money laundering ("AML") compliance programs under the Bank Secrecy Act ("BSA").[43] Very generally, covered financial institutions must establish adequate AML programs to guard against money laundering and other criminal activity. Such programs are effectuated in part through various record keeping requirements, the performance of due diligence regarding customers and their accounts, and the filing of suspicious activity reports ("SARs").[44] Especially in light of their AML/BSA responsibilities, and for the reasons discussed above, most financial institutions have been reluctant to conduct transactions involving marijuana proceeds or to have MRBs as customers.

That began to change somewhat in 2014, when, in conjunction with DOJ's issuance of the Cole Memo, the Department of Treasury — via the Financial Crimes Enforcement Network ("FinCEN"), which administers the BSA — issued a memorandum on its BSA expectations for financial institutions seeking to provide services to MRBs (the "FinCEN Guidance").[45] The FinCEN Guidance lifted the absolute prohibition against marijuana-related bank transactions and modified reporting requirements for suspicious transactions, in response to the expanding trend among the states to legalize the medical use of marijuana.[46] In August 2014, the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency each incorporated the FinCEN Guidance into their supervisory processes.[47]

But allowing financial institutions to bank MRBs comes with a steep price. The FinCEN Guidance places onerous compliance requirements upon financial institutions. Under the FinCEN Guidance, financial institutions must undertake regular due diligence reviews to "know their customers" in the marijuana industry. As part of this enhanced due diligence ("EDD"), banks must (1) regularly verify and review customer MRBs' state licenses and related documentation; (2) develop an understanding of each MRB's "normal and expected activity;" (3) monitor publicly available sources for adverse information about their MRB customers and related parties; (4) monitor MRBs for "red flags" of suspicious activity to identify outwardly legal MRBs that are fronts or pretexts for money laundering or marijuana-related activity not authorized by state law; (5) "consider whether a marijuana related business implicates one of the Cole Memo priorities or violates state law;" and (6) "refresh" the information obtained "on a periodic basis and commensurate with the risk."[48]

The FinCEN Guidance also requires financial institutions to file SARs, although modified to track, rather than investigate, legitimately operating MRBs and focus the government's investigative resources on

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[41] *McIntosh*, 833 F.3d at 1179 n.5.

[42] The *McIntosh* case did not address whether DOJ also was prohibited from spending funds to enforce the money laundering statutes – which are distinct from the CSA – in cases involving medical marijuana. Further, the Rohrabacher Amendment does not address the money laundering statutes. On the other hand, *Samp* at least suggests that the Rohrabacher Amendment may forbid prosecution for conduct which would otherwise be legal, but for its connection with a state-compliant marijuana business. *Samp*, No. 16-cr-20263, 2017 U.S. Dist. LEXIS 46291, at *4.

[43] 31 U.S.C. §§5311–5332.

[44] *See, e.g.,* 31 CFR § 1020.320 (requiring that "[f]inancial institutions shall file with [FinCEN] . . . a report of any suspicious transaction relevant to a possible violation of law or regulation"). The regulation also provides that "a financial institution may also file with [FinCEN] a [SAR] with respect to any suspicious transaction that it believes is relevant to the possible violation of any law or regulation" but whose reporting is not required by FinCEN regulations. *Id.*

[45] Financial Crimes Enforcement Network, FIN-2014-G001, BSA Expectations Regarding Marijuana-Related Businesses (Feb. 14, 2014), https://www.fincen.gov/resources/statutes-regulations/guidance/bsa-expectations-regarding-marijuana-related-businesses.

[46] *Id.*

[47] Board of Governors of the Federal Reserve System et al., Letter to the Honorable Jay Inslee ("Board of Governors' Letter") (Aug. 13, 2014), https://dfi.wa.gov/documents/banks/gov-inslee-interagency-response.pdf.

[48] FinCEN Guidance, *supra* note 46.

questionable and improper business activity.[49] Because marijuana is prohibited under federal law, *all* marijuana-related transactions processed by financial institutions are inherently suspicious. Therefore, the FinCEN Guidance requires a financial institution with an MRB as a customer to file one of three types of SARs: (1) "Marijuana-Limited" SARs to identify financial services provided to MRBs that, through a due diligence review, meet the state law requirements and do not violate the Cole Memo Priorities; (2) "Marijuana Priority" SARs on MRBs reasonably believed to violate state law or one or more of the Cole Memo Priorities; and (3) "Marijuana Termination" SARs in the event a financial institution terminates its relationship with an MRB customer "in order to maintain an effective" AML program.[50] Thus, a financial institution that does business with an MRB must file SARs regarding *all* of the financial services provided to that customer.

Adding to the regulatory burden associated with banking MRBs is the fact that financial institutions are obligated to file CTRs on the receipt or withdrawal of more than $10,000 in cash per day.[51] Since credit card networks generally will not provide services to MRBs, cash is the most common form of payment at dispensaries. Thus, dispensaries may routinely make deposits of over $10,000 in cash, but because an MRB is not eligible for any exemption from a bank's CTR filing obligations, a CTR must be filed for all such deposits.

Overall sales of legal cannabis within the U.S. reached $10.4 billion in 2018 and are expected to reach $17 billion by the end of 2020.[52] Thus, despite FinCEN's onerous requirements, in recent years, a growing number of financial institutions have been willing to do business with MRBs. FinCEN's most recent Marijuana Banking Update, which includes data through the fourth quarter of 2019, indicates that the number of depository institutions, such as banks and credit unions, actively providing banking services to MRBs increased from 512 in October 2018 to 739 in December 2019.[53] Since FinCEN issued its guidance requiring SARs for MRBs, it has received over 114,859 SARs, with the vast majority — 85,193 — being "Marijuana-Limited" SARs. In the first quarter of 2017, filings of "Marijuana-Limited" SARs increased significantly, while the number of "Marijuana Priority" and "Marijuana Termination" SARs remained relatively static, and that trend has continued.[54] Thus, while more banks and credit unions are accepting MRBs as customers, there has not been a corresponding increase in the amount of observed suspicious activity.

Assessing and Mitigating the Risk

As discussed above, because federal law continues to criminalize marijuana-related activity, there are a myriad of risks associated with providing financial services to MRBs. However, with the implementation of proper controls, such risks can be mitigated to a certain extent, although at a hefty cost.

As the FinCEN Guidance stated, whether to onboard MRB customers is a "risk-based decision."[55] Of course, the greatest risk is possible federal consequences, including prosecution and seizure of assets. That risk is small and growing smaller, provided a bank follows the FinCEN Guidance. A search we conducted could find no case in which a financial institution was prosecuted solely for providing services to a state-legal MRB. And financial institutions are unlikely to be sanctioned by their regulators either. Federal regulators adopted the FinCEN Guidance in 2014,[56] and, in August 2019, Rodney Hood, Chairman of the National Credit Union Administration, stated that credit unions will not be sanctioned for providing services to state-legal MRBs.[57]

Another risk a financial institution must consider is reputational. The bank must assess what its customer base and the communities it serves will think if the bank chooses to do business with MRBs.

A financial institution also must consider whether it can afford to bank MRBs — the related revenue could

[49] *Id.*

[50] *Id*.

[51] *Id*. *See also* 31 C.F.R. § 1010.311.

[52] Hudock, *supra* note 2.

[53] FINANCIAL CRIMES ENFORCEMENT NETWORK, MARIJUANA BANKING UPDATE (Dec. 2019), https://www.fincen.gov/sites/default/files/shared/291404_1st_Q_FY2020_Marijuana_Banking_Update_Public.pdf.

[54] FINANCIAL CRIMES ENFORCEMENT NETWORK, MARIJUANA BANKING UPDATE (Dec. 2018), https://www.fincen.gov/sites/default/files/shared/Marijuana_Banking_Update_Public_Dec_2018.pdf.

[55] FinCEN Guidance, *supra* note 47.

[56] Board of Governors' Letter, *supra* note 49.

[57] David Baumann, *CUs Won't Be Sanctioned for Providing Marijuana Banking: NCUA Chairman Hood*, CREDIT UNION TIMES, (August 5, 2019), https://www.cutimes.com/2019/08/05/cus-wont-be-sanctioned-for-providing-marijuana-banking-ncua-chairman-hood/?slreturn=20200515100037#.

be high, but so are the compliance costs. Does it have the financial wherewithal to implement and maintain AML/BSA and risk management programs with sufficient resources and systems to conduct the EDD and monitoring required by the FinCEN Guidance? Its monitoring and reporting processes must include resources commensurate with the risks to ensure proper CTR and SAR compliance. The financial institution's programs must be robust enough for it to know whether its MRB customers are in compliance with relevant state law and the Cole Memo Priorities. MRBs in violation of state law or one of DOJ's enforcement priorities are more likely to be targets of federal or state enforcement actions. And any financial institution servicing them is therefore also more likely to be a target. Implementing and maintaining robust risk management programs is costly, so before onboarding its first MRB, a financial institution should conduct a break even analysis.

As part of its risk assessment, the financial institution should establish risk limits. The limits could be based, for instance, on the number of MRB customers or accounts it will accept, or what percent of revenue MRB business should represent.

In assessing the risk of onboarding an MRB, a financial institution must conduct due diligence. Customer due diligence is mandated by the FinCEN Guidance and critical to understanding anticipated transactions and implementing a suspicious activity monitoring system in order to reduce the financial institution's reputational, compliance, and transaction risks. In addition to the due diligence listed in the FinCEN Guidance,[58] the EDD should include reviewing the MRB's financial records, including, but not limited to gross receipts, to determine the MRB's source of funding and so as to be able to compare those records to cash activity. The financial institution also should aggregate related account activity, such as personal accounts and related business accounts, for reporting purposes.

A financial institution should screen its MRB customers against state-licensed businesses on an ongoing basis and refresh all the information obtained as part of its MRB due diligence on a periodic basis and commensurate with the risk. Moreover, the financial institution should contractually require the MRB to notify the bank within five days of any material status change or adverse information, such as loss or suspension of its license or that it, or any of its principals (including owners and managers), are under investigation or arrest or have been convicted of a crime. The financial institution also could require the MRB to certify, on an ongoing basis, that its licensing status has not changed and that neither it nor its principals is the subject of any investigation or criminal prosecution.

The information gathered while conducting due diligence should be used to determine whether an MRB implicates one of the Cole Memo Priorities or violates state law. In making this determination, the financial institution should consider whether any of the red flags listed in the FinCEN Guidance are present. Furthermore, relevant employees, including legal staff, those responsible for conducting MRB due diligence, and those who will be providing services to the MRB, should receive targeted training at least annually.

CONCLUSION

Federal law continues to criminalize marijuana-related activity. Thus, facilitating financial transactions for an MRB could be deemed by the federal government to constitute money laundering. However, since DOJ issued the Cole Memo, DOJ and other federal agencies have generally been hands-off with marijuana-related activities, so long as those activities strictly comply with DOJ's eight enforcement priorities. Therefore, although there is no guarantee that state-sanctioned marijuana-related activity will not be prosecuted, such activity appears to be relatively low risk. Note, however, that this DOJ policy of prosecutorial restraint could change or end at any time.

The controls discussed in this article and in the FinCEN Guidance, if correctly implemented and maintained, should greatly mitigate the identified risks associated with doing business with an MRB. However, such controls are expensive, and no controls can remove all risk. Thus, a financial institution must determine how much risk it can tolerate, and if the benefits of banking an MRB outweigh what risk remains once controls have been implemented. ■

[58] FinCEN Guidance, *supra* note 46.