NASCENT MARIJUANA INDUSTRY STRUGGLES FOR ACCESS TO NORMAL FINANCING

BY JAMES A. KOHL, ESQ.

If you think owners of Nevada's recently legalized medical marijuana facilities will likely be swimming in cash, you are correct — but not in the way you probably expect. It will not be from high-profit margins or the large volume of sales they are expected to make; it will be because they do not have access to banking institutions and therefore, for the most part, will be cash-only businesses.

The crux of the problem is twofold. First, despite the legalization of medical marijuana by 23 states and the District of Columbia, marijuana is still illegal under federal law. As a result, traditional banks are not willing to accept funds from medical marijuana businesses for fear of prosecution. Second, to date the Federal Reserve has not approved any financial institution that services medical marijuana clients for a master account. A master account allows a financial institution to deposit money into a Federal Reserve branch where it is converted into an electronic credit. The institution can then transfer money between banks, using the primary nine-digit routing transit number. Without a master account, a depository is merely a vault. Because they have not had access to a financial institution with a master account, those in the medical marijuana industry have, for the most part, been forced to operate as cash-only businesses.

Marijuana Remains Illegal under Federal Law

Nevada, like many other jurisdictions, has legalized medical marijuana by enacting Nevada Revised Statutes 453A.010 et seq. Although the United States Attorney General has issued guidance on the prosecution of regulated marijuana activities, federal law still prohibits the medicinal and recreational use of marijuana. 28 U.S.C. § 801. Marijuana remains a Schedule I illegal narcotic, pursuant to the federal Controlled Substance Act (CSA). 28 U.S.C. § 801 et. seq. While physicians are able to prescribe drugs that are classified as controlled substances (e.g. morphine) under the CSA, physicians may not prescribe any Schedule I substances (ecstasy, LSD, marijuana, etc.) 21 U.S.C. § 812b.

On August 29, 2013, the Department of Justice (DOJ), through Deputy Attorney General James Cole, issued non-binding guidance regarding the government's goals for

enforcement of federal marijuana laws (the Cole Memo). The Cole Memo states that the federal government will defer prosecution in states that enacted marijuana regulations similar to Nevada's program. However, the federal government reserved its rights to prosecute marijuana activity not covered by Nevada's program, i.e. distribution of marijuana to minors, sale of marijuana across state lines, criminal enterprises involved in medical marijuana businesses, etc. Because marijuana has not been removed from Schedule I, the cloud of questionable legality continues to hang over state-regulated medical marijuana facilities.

Banks Remain Reluctant to Handle Marijuana-Derived Funds

Although the Cole Memo clarified what types of marijuana-related activities the federal government would prosecute, banks, credit unions and credit card processors were concerned because it did not address whether the federal government would prosecute financial institutions if they accepted funds derived from the sale of medical marijuana. The United States Department of Treasury Financial Crime Enforcement Network (FinCEN) regulations require financial institutions to file a Suspicious Activity Report (SAR) if they reasonably believe that a transaction involves illegal activity or an attempt to disguise illegal activity. 31 C.F.R. 1020.320. The Bank Secrecy Act (BSA) defines "financial institution" so broadly that any entity providing credit must file a SAR when handling funds derived from the medical marijuana industry. 31 U.S.C. 5312(a)(2)(A)-(Z). The breadth of the BSA and the requirement to file a SAR for every marijuana-related transaction is one of the primary reasons banks won't provide financial services to medical marijuana businesses.

continued on page 18

continued from page 17

NASCENT MARIJUANA INDUSTRY STRUGGLES FOR ACCESS TO NORMAL FINANCING

On February 14, 2014, FinCEN issued guidance (Guidance Memo) regarding compliance with the BSA and the requirements for filing SARs by financial institutions insured by the Federal Deposit Insurance Corporation (FDIC). The Guidance Memo restated and adopted the Cole Memo's goals for financial institutions. Additionally, the Guidance Memo expressly stated that "the obligation to file a SAR is unaffected by any state law that legalizes marijuana-related activity." The Guidance Memo created three new types of SARs for medical marijuana activities. If the bank feels that the marijuana business is complying with the Cole Memo's goals, a Marijuana Limited SAR is filed. The financial institution must file continuing activity reports while its marijuana business client operates within the stated policy goals of the DOJ as outlined in the Cole Memo, meaning continued compliance with state marijuana laws and regulations. If the financial institution determines its marijuana business customer is violating one or more of the policy goals from the Cole Memo, the financial institution files a Marijuana Priority SAR. This is a red flag to FinCEN that the marijuana business may be operating outside the bounds of DOJ policy goals. Finally, if the financial institution believes that it needs to terminate its relationship with a medical marijuana business due to anti-money laundering risks, it files a Marijuana Termination SAR and ends its relationship with the marijuana business.

FDIC-insured financial institutions are required to exercise safe and sound banking practices in conducting their business. 12 U.S.C. 1818(b)(1). An unsafe and unsound banking practice is one that results in abnormal risks. The risk of loss is the key to determining whether a banking practice is unsound. *See Running v. State Banking Bd. of Ill.*, 237 Ill. App. 3d 590, 604 (4th Dist. 1992) *citing Northwest Natl. Bank v. U.S. Dept. of Treasury Office of Comptroller of Currency*, 917 F.2d 1111, 1115 (8th Cir. 1990). The Cole Memo and the Guidance Memo are avenues FDIC-insured financial institutions may use to extend their services to state-compliant marijuana businesses, but they are not binding; banks, therefore, have been unwilling to rely on them. The question of whether or not it is safe and sound banking practice to follow non-binding guidance that facilitates technical money laundering under the BSA (18 U.S.C. 1956, 1957) needs to be addressed with additional FinCEN guidance or through congressional action. Until such time as that happens, federally regulated banks will continue to shy away from accepting medical marijuana funds.

Credit Unions May Provide an Interim Solution

Credit unions may be the best hope for medical marijuana businesses seeking access to a financial institution with a master account. Credit unions have traditionally provided banking services to groups that banks have not. The principals behind a credit union to be formed in Nevada — Battle Born Credit Union — hope to be the first financial institution catering to medical marijuana businesses to obtain a master account. Battle Born intends to apply for a state charter, acquire private insurance and limit its activities to within Nevada's borders. Battle Born studied the policies and procedures used by Nevada's casinos to detect and prevent money laundering and used those techniques to develop proprietary software that will allow it to comply with the strict BSA/SAR reporting requirements. Battle Born hopes that all of the above will help it convince the Federal Reserve to grant it a master account. The medical marijuana industry will be closely monitoring Battle Born's application.

Even after a financial institution that deals with medical marijuana businesses obtains a master account, there will be issues to work out. For example, how does one secure a loan to a medical marijuana dispensary? Typically lenders take blanket liens on a business' equipment and inventory. While marijuana appears to be valuable, and it could be pledged as collateral for a loan, upon default, a lender would not be able to take possession of the marijuana because it is not licensed to do so. To a lender, marijuana's value as collateral is zero. Lenders will have to look to principals for personal guarantees, or secure their loans with collateral other than the business' marijuana. Nevada's medical marijuana businesses will almost certainly pay higher interest rates to offset the perceived risk of banking the industry.

Policy is Evolving, But Risks Remain

The Guidance Memo is FinCEN's attempt to welcome financial institutions into the growing marijuana business and meet the objectives of the Cole Memo. By enabling financial institutions to serve customers in the marijuana business, there will be account recordkeeping of the cash generated by the industry. These financial records will act as fingerprints for any improprieties by less reputable businesses. However, until such time as financial institutions are approved for master accounts, Nevada's medical marijuana businesses will remain cash-and-carry businesses with all the attendant risks. NL

JAMES A. KOHL is an attorney, mediator and arbitrator. For the last 20 years he has practiced in all phases of commercial litigation, handling a variety of cases in multiple industries and fields. Kohl also advises business owners in the creation, acquisition and disposition of entities and real estate. He can be reached at jkohl@howardandhoward.com.