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COMPLIANCE

The Legalized Marijuana Industry's Evolution Is an Exercise in Banking Compliance

By Zane Gilmer

On Jan. 1, recreational marijuana officially went on sale in Colorado, marking the first state in the Union to permit the recreational sale and use of marijuana. For the last year — following the passage of Amendment 64, which legalized recreational marijuana in Colorado — state and federal officials have been working diligently to put together a comprehensive set of regulations to address the new industry. Most of those regulations have focused on the operations of marijuana stores and restrictions related to possession and consumption of the product.

The recreational marijuana industry, however, does not just affect sellers and purchasers. Rather, because the cultivation, possession and distribution of marijuana remain illegal under federal law — and, for that matter, the laws of 48 states in the Union[1] — this first-of-its-kind industry, like the more common medical marijuana industry, poses unique compliance issues for businesses across many different industries. And perhaps no other industry is more affected than the banking industry. This article addresses some of the key compliance issues facing bankers following the legalization of recreational marijuana.

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The 'Cash Only' Business Problem

Recreational marijuana sales reportedly almost topped $5 million in just the first week the product was sold in Colorado. Because recreational — and even medical — marijuana businesses operate largely on a cash-only basis, the large volume of revenue has left many marijuana business owners struggling to figure out what to do with all of that money. Unlike other businesses, marijuana businesses cannot just go to their local bank and open an account. Rather, because the possession and distribution of marijuana is still illegal under federal law, banks are reluctant to engage in business with marijuana-related businesses.

The Bank Secrecy Act, for instance, requires banks to monitor money passing through their institutions for potential money laundering.[2] To comply with their anti-money laundering obligations, banks are required to file Suspicious Activity Reports (SARs) related to transactions they suspect involve potential money laundering. Because the sale and distribution of marijuana is illegal under federal law, any proceeds flowing from those transactions would be proceeds of an illegal transaction and, therefore, raise immediate and serious money laundering concerns.[3] Failure to file a SAR for a reportable activity could result in criminal or civil fines

[1] In 2012, the State of Washington also legalized recreational marijuana, but sales will not begin there for several months.

[2] 31 U.S.C. § 5311, *et seq*.

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and other penalties against the bank and any involved employees.[4] What is more, banks accepting deposits from marijuana-related businesses face potential criminal liability for ''aiding and abetting'' the commission of a federal offense. Thus, even routine banking transactions, such as opening a savings or checking account for a small recreational marijuana start-up company, can be lurking compliance pitfalls for banks.

Interestingly, the Bank Secrecy Act notwithstanding, at least three banks have agreements with the State of Colorado, permitting them to receive and bank state funds.[5] Those funds include sales tax revenues collected from the sale of recreational and medical marijuana and, as such, are proceeds of a federal offense. It is unclear how the federal government will treat banked tax revenues generated from the sale of marijuana but, until further guidance is provided by the federal government, the banking industry should use caution when deciding to bank such tax revenues.

Lack of Legitimate Access To Credit Card Networks

The marijuana industry's lack of access to banking also means a theoretical lack of access to the major credit card networks. That is, credit card merchants must have a bank account in order to clear each credit card transaction. This, however, has not stopped all marijuana-related businesses from accepting credit cards. Rather, some recreational marijuana stores have reportedly been accepting credit card payments by concealing from the credit card companies and banks the true nature of the transactions. Some have set up ''shell companies'' to funnel transactions through, while others have taken advantage of the credit card networks' so-called ''merchant category classification'' (MCC) codes. MCC codes are numbered classification codes assigned by the credit card companies to identify certain types of merchants (e.g., veterinary services, landscaping services, grocery stores, etc.). Because the sale and distribution of marijuana is still illegal under federal law, the credit card networks do not have MCC codes for marijuana retailers. Marijuana shops, therefore, disguise their transactions by using innocuous MCC codes assigned to other merchant types so as not to raise any ''red flags'' with the credit card companies or the banks. In light of banks' ''know your customer'' obligations,[6] this type of deception and ''work around'' by marijuana businesses can cause serious compliance issues for banks.

And if the foregoing was not challenging enough, just a week into recreational marijuana sales in Colorado, credit card giant Visa advised it will not strictly enforce its policy prohibiting the use of its credit card network to purchase recreational marijuana.[7] Rather, Visa put the onus on the banking industry to ''make any determination about potential illegality.''[8] Such a policy is not only a risk for banks, but also the credit card companies for the same reasons. That is, to the extent banks are liable for ''aiding and abetting'' a federal offense, then arguably so too are credit cards companies.

Compliance Risks Go Beyond Maintaining Marijuana-Related Accounts

The legal risks to banks are not just limited to maintaining accounts related to marijuana-related businesses. Rather, banks must be vigilant in conducting any business with marijuana-related businesses. Extending loans, for instance, can be extremely problematic to the extent the proceeds of those loans will be used for marijuana-related business (which they presumably will be in most, if not all, instances). This, in turn, can lead to federal ''aiding and abetting'' liability in the context of federal drug offenses. The same, of course, is true for loans extended to developers or landlords for use in ''build-outs'' for commercial space intended for use by a marijuana-related business.

Extending loans to marijuana-related businesses also threaten to create conflicts with provisions found in typical loan documents. Many loan documents, for instance, require borrowers to warrant that they are currently, and will continue to be, in compliance with ''the law'' (including federal law), and will not use proceeds of any loan for any ''illegal activities.'' Borrowers involved in the recreational and medical marijuana industry cannot currently make those warranties. And even if the borrower did make the representations, the lender may face a variety of borrower defenses, including waiver and estoppel, if it ever decides to call the loan based on those covenants. Consider also that assets of marijuana-related businesses are subject to forfeiture as a result of federal criminal proceedings and investigations.[9] If a bank takes a security interest in the assets of a marijuana-related business as collateral for a loan, the bank may lose its security if those assets are later seized by the federal government.

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[3] ''Money laundering is the process by which one conceals the existence, illegal source, or illegal application of income, and disguises that income to make it appear legitimate.'' *U.S. v. Shepard*, 396 F.3d 1116, 1120 (10th Cir. 2005).

[4] DOJ Press Rel. 12-1478: HSBC Holdings Plc. and HSBC Bank USA N.A. were fined $1.256 billion and entered into a deferred prosecution agreement with the U.S. Department of Justice for violations of the Bank Secrecy Act. The violations resulted from HSBC's failure to maintain an effective anti-money laundering program to prevent, among other things, Mexican drug cartels from laundering drug proceeds through HSBC accounts, Dec. 11, 2012, available at http://www.justice.gov/opa/pr/2012/December/12-crm-1478.html.

[5] State of Colorado, Department of Treasury, Cash Management Division: http://www.colorado.gov/cs/Satellite/Treasury_v2/CBON/1251590262877.

[6] Financial Crimes Enforcement Network Joint Release, FIN-2010-G001, ''Guidance on Obtaining and Retaining Beneficial Ownership Information,'' March 5, 2010, p.1 (''The requirement that a financial institution know its customers, and the risks presented by its customers, is basic and fundamental to the development and implementation of an effective BSA/AML compliance program.'').

[7] Hadley Malcom, *Credit Cards Squeamish About Charging Pot*, USA Today, Jan. 13, 2014, available at http://www.usatoday.com/story/money/business/2014/01/13/credit-debit-card-acceptance-marijuana/4392611/.

[8] Hadley Malcom, *Credit Cards Squeamish About Charging Pot*, USA Today, Jan. 13, 2014, available at http://www.usatoday.com/story/money/business/2014/01/13/credit-debit-card-acceptance-marijuana/4392611/.

[9] *See e.g.* 21 U.S.C. § 853 (criminal forfeiture statute related to controlled substance violations); 18 U.S.C. § 981, *et seq*. (civil forfeiture statute related to money laundering).

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Treasury and Justice Guidance Coming

On Jan. 23, U.S. Attorney General Eric Holder Jr., in response to the growing marijuana banking dilemma, announced that the U.S. Treasury Department and Department of Justice (DOJ) will soon release guidance aimed at permitting the legal marijuana industry access to banks.[10] It is unlikely, however, that guidance from Treasury or DOJ will adequately address all of the banking compliance risks associated with the marijuana industry.

Indeed, DOJ previously stated that it will not directly challenge Colorado's voter-approved recreational marijuana laws, but that its prosecutors should use discretion, based on certain DOJ priorities, in deciding whether to bring enforcement actions, including prosecutions.[11] The yet-to-be released DOJ guidance will likely focus on further defining those priorities and prosecutorial discretion. It is unlikely that DOJ will give the ''green light'' to banks to begin engaging the marijuana industry at will. For banks, such guidance on the exercise of unpredictable prosecutorial discretion will be of little help. Indeed, even guidance directing DOJ prosecutors not to prosecute or investigate banks for conducting business with ''legitimate'' or otherwise ''legal'' marijuana-related businesses raises further questions. For instance, who would determine whether the marijuana-related business is ''legitimate'' or otherwise operating in a ''legal'' manner? Would banks be required to conduct their own due diligence on marijuana-related businesses prior to engaging in business with them to ensure they are in compliance with the law? If so, will banks face liability if they conduct due diligence and are wrong? These questions, and many others, will likely remain unanswered.

Congressional Reform May Be Coming

Meanwhile, Congress is considering a bill introduced on July 10, 2013, as the ''Marijuana Businesses Access to Banking Act of 2013'' (H.R. 2652).[12] The bill's stated goal is to ''create protections for depository institutions that provide financial services to marijuana-related businesses.'' If passed, the legislation would prohibit federal banking regulators from: (1) terminating or limiting depository institutions' access to deposit insurance pursuant to the Federal Deposit Insurance Act; (2) punishing depository institutions that conduct business with marijuana-related businesses; (3) encouraging or enticing a depository institution not to conduct business with any individual solely because the individual is engaged with a legitimate marijuana-related business; and (4) taking an action on a loan of an owner or operator of a legitimate marijuana-related business or real estate or equipment that is leased to a legitimate marijuana-related business, solely because it is a marijuana-related business.

The bill would also provide immunity from federal prosecution or investigation of banks engaged in business with legitimate marijuana-related businesses. Moreover, the bill seeks to shield from forfeiture collateral securing loans made by banks to legitimate marijuana-related businesses.

The bill is currently in the House Judiciary Subcommittee on Crime, Terrorism, Homeland Security, and Investigations and it is unclear if, and when, it may be up for a vote. But, even if the bill passes and is signed into law by the president, like the expected guidance from Treasury and DOJ, it will not address all of the existing marijuana-related compliance issues facing the banking industry today. That said, there can be no question that it would provide some much-needed clarity to a few of those issues. And, most importantly, unlike guidance provided by Treasury and DOJ, a law passed by Congress and signed by the president would not be advisory or discretionary.

Future Considerations for Banks

Even if Treasury and DOJ release guidance or Congress passes legislation concerning the myriad of marijuana-related banking issues currently facing both industries, many compliance issues will likely remain. Banks, for instance, will have to grapple with designing and drafting internal policies that provide adequate training and guidance to their employees when dealing with the marijuana industry. For national banks, that exercise will be further complicated by the fact that recreational and medical marijuana laws vary by state. Further, banks will likely have to develop thorough due diligence procedures to scrutinize prospective marijuana-related businesses prior to conducting business with them. That will require, of course, becoming familiar with the ever-changing marijuana-related regulations and laws. Banks may, in turn, require assistance from their in-house or outside attorneys, who may be prohibited ethically from providing that much-needed assistance.[13] This will all, undoubtedly, require additional administrative and legal costs for the banking industry. All of which will have to be fully considered and balanced against the potential profits to be gained from engaging the marijuana industry.

What is clear is that regulating the recreational and medical marijuana industry is a work in progress. As a consequence, banks and other businesses must remain cognizant of those evolving regulations, and must seek experienced compliance counsel to ensure they do not run afoul of the law and their compliance obligations.

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[10] Jack Healy and Matt Apuzzo, *Legal Marijuana Businesses Should Have Access to Banks, Holder Says*, The New York Times, Jan. 23, 2014, available at http://www.nytimes.com/2014/01/24/us/legal-marijuana-businesses-should-have-access-to-banks-holder-says.html?_r=0.

[11] James M. Cole, ''Guidance Regarding Marijuana Enforcement,'' U.S. Department of Justice, Aug. 29, 2013, available at http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.

[12] Marijuana Businesses Access to Banking Act of 2013, H.R. 2652, 112th Cong. (2013), available at https://www.govtrack.us/congress/bills/113/hr2652/text.

[13] Colorado Rule of Professional Conduct 1.2(d) (''A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal . . . .''); Colorado Formal Ethics Op. 125 — *The Extent to Which Lawyers May Represent Clients Regarding Marijuana-Related Activities* (Adopted October 21, 2013; Addendum dated Oct. 21, 2013) (''To the extent [the lawyer's] advice were to cross from advising or representing a client regarding the consequences of a client's past or contemplated conduct under federal and state law to counseling the client to engage, or assisting the client, in conduct the lawyer knows is criminal under federal law, the lawyer would violate Rule 1.2(d).'').