

Payments Pros – The Payments Law Podcast: Chronic Payments: Unraveling the Complexities of Cannabis Banking**Hosts: Keith Barnett and Carlin McCrory****Guests: Jean Smith-Gonnell and Agustin Rodriguez****Keith Barnett:**

Welcome to another episode of *Payments Pros*, a Troutman Pepper podcast focusing on the highly regulated and ever evolving payment processing industry. This podcast features insights from members of our fintech and payments practice, as well as guest commentary from business leaders and regulatory experts in the payments industry. My name is Keith Barnett and I'm one of your hosts of the podcast. And before we jump into today's episode, let me remind you to visit and subscribe to our blog, ConsumerFinancialServicesLawMonitor.com. And don't forget to check out our other podcast on Troutman.com/Podcast. We have episodes that focus on trends that drive enforcement activity, digital assets, consumer financial services and more. Make sure to subscribe to hear the latest episodes. Today, Carlin and I are joined by our colleagues, Jean Gonnell and Augustine Rodriguez to discuss how financial institutions are navigating the rapidly evolving cannabis industry. Jean and Augustine, we are looking forward to the discussion today. So welcome.

And before I turn it over to Carlin, I just want to give a little bit of background. We felt the need for this episode because the payments and banking world has intersected with the cannabis world over the past few years. And while recreational marijuana is legal in most states, it's a cash business because marijuana is not legal on a federal level. And this presents a dilemma for banks and payment processors when it comes to anything from loans to payroll to payments to vendors and for legal transactions. The cards have said that they are not going to process payments for goods that are unlawful federally, and ACH payments must go through the Federal Reserve. So our hope with today's episode is to give everyone in the payments world an understanding of cannabis and payments. And with that, I'll turn it over to Carlin.

Carlin McCrory:

Thanks, Keith. Really looking forward to this episode and we'll go ahead and kick it off. Augustine, will you tell us a little bit about what you think financial institutions should be thinking about when it comes to the banking of cannabis?

Agustin Rodriguez

Yeah, sure. Thanks Carlin, and thanks Keith for having Jean and me on your show. I'm the co-head of our cross-functional cannabis team here at Troutman Pepper. We've got over 40 attorneys on our team. We're helping clients throughout their business cycle enter or expand into the cannabis space, and I love the cross-functional multidisciplinary challenges that this space brings. To answer your question, I think that financial institution should be thinking about four or five questions broadly. One is what is cannabis exactly? And understanding the basics of cannabis. Two is how does the federal government today approach cannabis? Three is precisely how are the states in which the bank or financial institution and its clients are located regulating cannabis? And fourth, what are the specific expectations that are placed on financial

institutions in this environment? So I think those are the questions that at a high level, that's how I would answer your question.

Carlin McCrory:

So then going back to your first answer, can you Jean, tell us a little bit about cannabis and what is it exactly?

Jean Gonnell:

Cannabis is a plant that actually by law encompasses both marijuana as well as hemp. For the majority of the purposes of this conversation, we'll be focused on marijuana. Now, marijuana is a plant that is federally illegal, and the difference between marijuana in large part is the fact that marijuana is a plant that includes high THC levels. And THC is the cannabinoid that causes the high, the euphoria that a lot of people seek when they use cannabis type products. Now all cannabis plants have over about 100 different cannabinoids, which are different compounds within the plant, but the THC is the most important cannabinoid for purposes of legality and even further, Delta-9 THC is what the major difference is because any cannabis plant that has over 0.3% of Delta-9 THC is going to be considered marijuana. And thus, federally illegal.

Since 1970, the Controlled Substances Act has banned the sales of cannabis, specifically marijuana. This act was enacted by President Nixon, the goal of which was to effectively regulate substances that were deemed to be potentially harmful. Marijuana is a Schedule 1 drug under federal law, meaning that currently the federal government believes that there's a high potential of abuse, no current medical treatment, and there's a lack of accepted safety without medical supervision. Since 1970, different states have enacted different state laws pertaining to marijuana specifically. Colorado actually had a constitutional amendment in 2000 that legalized medical marijuana and that was done by the voters amending the constitution. Washington also followed suit with Colorado and was the first to legalize medical marijuana. In 2012, the voters in Colorado then further amended the state constitution for allowing recreational use and possession of marijuana, allowing for stores to start selling the products in January of 2014. And again, Washington and Colorado were the first states to enact these regulatory systems.

Now these regulatory systems are very, very intense and highly regulated. There are multiple requirements starting with seed to sale systems, which essentially means that once the plant is in the ground and it reaches over eight inches by eight inches, it has to be tagged and RFID tagged and put in a system to be tracked all the way through to the sale to a consumer. No data is taken actually about the consumer unless it's medical, and of course there's a registration card and registry types of differences there. But generally, for adult use, everything goes with the RFID tag from the cultivation facility to either a manufacturing facility to make different products or directly to a store and then sold to a consumer.

In addition to seed to sale tracking, there's robust testing requirements that marijuana has to go through. Most states are slowly but surely following both Washington structure and Colorado structure to ensure that testing happens for these products to ensure their safety. Pesticide testing, potency testing, yeast and mold testing. These are just a couple of different tests that have to be run on every single product after it has been harvested and before it can be sent to a store to actually be sold to a consumer.

Additionally, all of those testing requirements and all of those testing findings are actually put on the labels for the consumers to be aware of what exactly it is their purchasing. The same thing applies to if these companies are turning these products into edibles, and there's a multitude of different types of marijuana products that the manufacturers make from chocolates and gummies to drinks, to lotions, to suppositories. There's a full gamut of different types of marijuana products. And all of those products, even after production, have to be tested. It's so strict that at this point, it is required that if you have a marijuana product and you decide to roll a joint and you've already tested it, you have to retest that product after it's been rolled because you added additional components to the product. It's a very, very thorough system, but all of the licensees are required to go through this process.

In addition to those types of requirements, there's security requirements. All dispensaries have security surveillance requirements with no less than 40 days security footage for purposes of inspections in case there's some sort of criminal acts that have taken place at the premises. And those types of records have to be available to the governing agencies. In Colorado, it's the Colorado Marijuana Enforcement Division, and every state has their own system that essentially follows the same vein where everyone has to follow these basic tenants of marijuana law. And everything is just very, very monitored. In fact, every year all the licenses have to be renewed. And during that renewal process, the licensees have to supply any new updated financial data, any updates to leases, updates to floor plans, because these facilities are routinely inspected by both state authorities and in lots of jurisdictions, including Colorado, local jurisdictions and local jurisdictions routinely come into facilities just to inspect fire escapes and checking the DVR system to make sure their surveillance and looking at the packaging to make sure that all of those label requirements have been met.

There's also a giant push to make sure that advertising doesn't happen because the legislature and the enforcement agencies want to ensure that there's not any push to advertise to children. And so a lot of states actually ban any type of animal or flower and won't let marijuana companies use those types of advertising tools that might be appealing to children.

Now, the difference between marijuana and hemp is very important in a couple of different aspects. In 2018, the Farm Bill actually passed and allowed for hemp to be federally legal and under the Farm Bill that was actually very specific, and it states that as long as the THC Delta-9 stays below the 0.3%, its hemp, federally legal, and people can sell it and use it for all sorts of purposes. What we've seen is a lot of companies have decided to make CBD products. I think everybody in this country at some point has seen a CBD product in a grocery store or elsewhere. Unfortunately, that has bred some other issues that we'll get into in a second. But the bottom line is the THC Delta-9 is the most important component of the Farm Bill, which decides whether or not it's falling into hemp, federally legal, or if it's not going to be hemp and it's marijuana, thereby federally illegal and changing the landscape related to legality.

Hemp itself, these are bigger plants in large part than marijuana plants. You see them outdoors, they tend to be taller, skinnier, and a lot of the plants are harvested during the summer in colder locations like Colorado in the winter, it gets very cold starting in October. So they're planted in April, they're harvested in October, and the majority of the hemp plants are turned into biomass. So they essentially mulch it and they give it to manufacturers, and the manufacturers put it through a process to pull out the cannabinoids that they ultimately really care about. But the problem has now become that a lot of hemp companies have figured out that Delta-8 and Delta-10 cannabinoids can actually be utilized through different processes and synthesized to become

intoxicating. And so that has become quite a problem. And in states like North Carolina for example, you can walk down the street and see signs for Delta-8 products and THC, and those are hemp products that have been synthesized to make intoxicating products that are not being regulated and not being tested for safety purposes.

Recently, actually in Arkansas, Arkansas's legislature passed a bill stating that Delta-8 and Delta-10 products could no longer be produced and sold in Arkansas. That has now been enjoined and is in federal court in Arkansas based on the facts that the Farm Bill only parses out Delta-9 as being the cannabinoid and the issue pertaining to illegality, that's the only defining factor. And Delta-8 and Delta-10, regardless of their THC content is not a Delta-9 intoxicant. And so those products are legal under federal law, but things are slowly changing in that aspect of the world in large part, especially because a lot of states don't want unregulated chemicals that are intoxicating to be given to the public. And I think that makes quite a bit of sense frankly, in a lot of states that have legal marijuana, like Colorado does not allow sales of Delta-8 and Delta-10 products out of the gate.

Carlin McCrory:

That's all really interesting, Jean, and I want to open up the floor to talk a little bit more about payments and what this really means for financial institutions. And you touched on the fact that it's still federally illegal as we all know. So then how does this work together with the federal government regulating cannabis along with the impact on financial institutions?

Agustin Rodriguez

Many of your listeners are probably already aware that there's certain federal statutes that make it a federal crime to transmit money that's derived from illegal activity. The Controlled Substance Act is one that Jean was referring to earlier, but you've also got a couple of other acts. You've got the Bank Secrecy Act, you have the Unlicensed Money Transmitter statute, you've got the Money Laundering Control Act, and these form the core pieces of the federal legislative framework that directly impacts banks that may serve marijuana or marijuana related businesses. I'm going to call this MRBs from time to time. The BSA, the Bank Secrecy Act enlists domestic financial institutions to assist law enforcement in the tracking and monitoring and reporting of financial crimes, and requires financial institutions to establish anti-money laundering programs, and to report illegal and suspicious activities to the Federal Crimes Enforcement Network, which is also referred to as FinCEN.

The Unlicensed Money Transmitter statute imposes fines and or imprisonment on anyone who knowingly conducts, controls, manages, supervisors, directs, or owns a money transmitting business that affects interstate or foreign commerce and involves the transportation or transmission of funds that are known to have been derived from a criminal offense.

And then the Money Laundering Control Act, that's prohibiting knowingly conducting certain transactions that involve the proceeds of specified unlawful activities. And those specified unlawful activities include dealing in a controlled substance. And so as Jean said earlier, cannabis is on Schedule 1 of the DEA under the Controlled Substance Act, so cannabis gets picked up there too.

But despite the existence of these federal statutes in 2014, there was some significant developments that occurred at the federal level that are worth discussing. In 2013 and 2014, under what then was the Deputy Attorney General James Cole, there are a couple of memoranda that were issued. 2013, there was memorandum issued by Deputy AG Cole that listed out essentially those priorities that the Department of Justice was going to focus on in recognition of the fact that the state legal regimes that Jean was referring to out there have proliferated. And I think as of that time, there might have been already 20 states that had state legal regimes.

And so there's an attempt by the federal government literally to accommodate those state legal regimes and set out priorities that effectively instructed federal prosecutors to consider when allocating their resources. We'll talk a little bit more about that, but basically that first was issued in 2013 focusing on the cannabis industry itself. And then in 2014 there was another memo issued under James Cole's name that notified federal prosecutors that they should follow those same priorities set forth in the 2013 memo, when deciding whether to prosecute financial crimes under the BSA, the Unlicensed Money Transmitter statute and the Money Laundering Control statute. And then concurrently with the 2014 memo, FinCEN issued guidance to clarify how financial institutions can provide services to MRBs consistent with their BSA obligations.

And it's worth noting that the Bank Secrecy Act does not explicitly prohibit financial institutions from serving marijuana businesses. Instead, this 2014 guidance from FinCEN imposes significant regulatory due diligence and reporting requirements on financial institutions that serve MRBs and want to remain in compliance with the BSA. In a nutshell, the FinCEN guidance notes that you've got a lot of discretion as a financial institution. It's your decision whether to open, close or refuse any particular account or relationship. It encourages the financial institutions to do so based on a number of factors and the bank's capacity to manage risk. And so essentially, the guidance which is public, and I encourage all of you to read it, focuses on compliance, it focuses on due diligence, it addresses the BSA. It does not directly address the two other statutes I mentioned, the Unlicensed Money Transmitter statute and the Money Laundering Control Act. The latter two really need to be looked at through the lens of the priorities in the Cole Memos and I think are really more about how DOJ approaches enforcement of those statutes as opposed to how FinCEN approaches it.

But FinCEN is really looking at and is instructing financial institutions to look at these red flags, to look out for red flags. Red flags are things like signs that the business is laundering money for illegal operations, such as by receiving more revenue than one would expect in a given transaction or series of transactions, or making cash deposits or withdrawals over a period of time that are excessive relative to the expected activity of the business. You have to make sure you're getting their licenses, you have to understand how they operate. And so you have to know when a business is unable to produce satisfactory documentation or evidence to demonstrate that it's duly license or operating consistently with state law. That's a red flag.

Another red flag is when the business is unable to demonstrate the legitimate sources to significant outside investments. I'm not going to go through all of them. There are a number of them. There are quite a few of these that are red flags that are listed, and it's a non-exhaustive list, but step one under FinCEN guidance is be on the lookout for those red flags. Step two is what do you do about that? And there, what FinCEN instructs you to do is to engage in a process of filing suspicious activity reports or SARs. And these reports I'm sure many of you already familiar with. They are in existence already for anti-money laundering purposes, but

they're also expected to be used in the marijuana context. They're designed to be useful in criminal investigations and proceedings.

And so basically, they boil down to three types. There's a marijuana limited SAR that you file where you're working with a company or you're banking a company, an MRB, that is engaged in marijuana activities, but they do not implicate the Cole memo priorities. And there you're filing this marijuana limited SAR, and there's some basic things that you include in that. Information about subject parties, the fact that the SAR is being filed solely because the subject is engaged in a marijuana related business and the fact that no additional suspicious activity has been identified. And then you're expected to file continuing activity reports in accordance with existing guidance.

And then if there's a change in activity, you're supposed to monitor that activity, as I said earlier, and if there's a change in that activity that implicates a Cole memo priority, then a second type of SAR filing pops up, and that's a marijuana priority SAR. These marijuana priority SARs, again, are to be filed when you encounter one of these red flags. These are things that you're already keeping an eye out for. Again, we talked about some of those flags earlier. There's quite a few of them. And when you come across one of them, you're expected to file a priority SAR in which you provide details regarding the enforcement priorities that you believe have been implicated. Dates, amounts, other relevant details of the financial transaction that involved the suspicious activity. You have quite a bit of discretion in how you do it.

But ultimately there's a third type of filing and that's called a marijuana termination SAR. That happens if you as a financial institution deem it necessary to terminate a relationship with an MRB in order to maintain an effective anti-money laundering compliance program. And there you would file this particular SAR and you would note in the narrative the basis for the termination.

There's a few other bells and whistles in the guidance. I'm not trying to summarize it entirely. Things like currency transaction reporting reminders. FinCEN would love it if you use the 314B voluntary information sharing to notify other financial institutions that you're aware of that are interacting with this customer. But with all this guidance, we like to tell our banking clients that service the industry to, number one, again, be cognizant of the circumstances and of the regulatory landscape. Number two, insist on transparency with your customers. And what that means too, by the way, is that you know their business, you know their business enough that you can recognize their standard business transactions, you know whether they're medical or adult use, you know when they're forthcoming, when they're not. And that may mean that you're hiring employees out of the cannabis industry to help in your compliance program. Make sure they're forthcoming. It's in everyone's interest to be open, honest, and transparent about the business. They shouldn't be pretending to be a florist or an herbal supplement company, and you shouldn't be helping them to do that.

All this just goes to really establishing a credible audit and compliance program that brings all of this together, all of these red flags and all of this FinCEN guidance into a unified strategy where you have a strategy as to what you're trying to accomplish, you know what your resources are for compliance and how you're going to match that up against the risks that you're willing to take on. You're in alignment internally with your board of directors, you're in alignment with your regulator and you have a clear program.

FinCEN can tell you there's actually plenty of financial institutions that are in this area that are doing this work, but it requires a very serious and careful approach to doing it. And so it's really about defining your strategy and how you're going to make money while managing your risks. One thing I'm going to just mention here and maybe turn it over to Jean is that Jean, everybody's asking about this letter from HHS to the US Drug Enforcement Administration that's requesting that the DEA reschedule marijuana from Schedule 1 under CSA to Schedule 3. So what do you think about that? Is it going to help banks and or marijuana companies seeking financial services?

Jean Gonnell:

No, I don't think it will. Merely taking marijuana from a Schedule 1 to a Schedule 3, all of that really does is require doctors to provide prescriptions for marijuana. And let's be honest, doctors are not going to be prescribing anybody any smokeable flower as any type of health safety measure to start with.

The other issue though is outside of just medical, and if medical was Schedule 3 and people had to go to pharmacists after doctors, that just only deals with medical. That won't touch the recreational component of things because the recreational component in a lot of different states have state statutes that require recreational marijuana being handled and treated like alcohol, which again is vastly different than treating it like a prescription drug. Schedule 3 prescription drugs include steroids, Tylenol, codeine, those types of different drugs that you have to go see a doctor for. And the likelihood of doctors providing any type of prescription for anything outside of potentially suppositories or lotions, those types of products, definitely not the gummies and the chocolates and the drinks that we see in the market that take up a very large actual market share in marijuana.

Agustin Rodriguez

It's an interesting development at one level, but it really goes more into this world of researching cannabis and how to allow you to prescribe if FDA lets you. I don't think it's going to affect federal enforcement. They're not going to be inclined to vigorously enforce Schedule 3 violations that they weren't particularly enthused about enforcing when they were on Schedule 1. So whether this gives Congress a kick in the rear to legalize, I don't know, but it's Congress, so it's going to take a while for that to play out.

Keith Barnett:

Jean, can you tell the audience what banks and other financial institutions are actually doing to participate in the cannabis marketplace?

Jean Gonnell:

Yes. A lot of state-chartered credit unions are in the space. I wouldn't say a lot, but there are banks that do allow for cannabis banking and really just deposit accounts. These bank accounts are opened up after a very lengthy process of due diligence and getting to know the customer and understanding what their data includes as far as balance sheets, profit sheets, projections, licenses, you name it. They go through this entire process to get a bank account and then they're deposit accounts only. And what tends to happen in these bank accounts and how

they're operated is A, the bank always charges a monthly fee, and it's about \$1,000 a month right now. As recent as 2016, it was up to \$2,500 a month with some banks charging for every single transaction. And there's been numerous people I've spoken to in the industry who were paying banking fees of upwards of \$500,000 a year because they had to pay for not just the monthly fee, but every single transaction they were being charged for.

Luckily, that has changed quite a bit. And so the deposit accounts still charge monthly fees, but not transaction fees for every single transaction. But what the banks are doing is every day they sweep the accounts from the deposit account and put into a companion account, and that's where the actual money sits. Whether or not that's interest bearing, obviously it's up to the bank, but my clients are not seeing any interest from those deposit accounts or any of the benefits that the bank is likely signing.

Some of the other questions a lot of people ask is lending. Banks don't lend to marijuana companies. Private equity lenders lend to marijuana companies, and a lot of those loans have interest rates up to about 20%. It would be a great industry for banks to want to get into potentially, but at this moment, there's not been a single transaction I have ever seen that has a bank loan involved. And there is even some trepidation related to real property being bought for a marijuana entity. And so that's why in marijuana, you always see real property held by one entity, and you always see a licensed entity being completely separate because you need to make sure that there's very clear lines between both entities with leases, and there's also some tax issues involved there, but that's what banks really want to take a look at. Even title companies at one point wouldn't close on real property in relation to marijuana businesses.

But things have evolved a little bit, so you're not seeing nearly as many problems when it comes to title companies and that sort of thing, but especially for banks, you're seeing a lot more banks interested in getting involved and going through those procedures, but they're very hefty procedures for the banks to continue following.

Keith Barnett:

Right, and one other area that banks and financial institutions have been getting involved, or at least fintechs has been payroll. So people are not paid with straight cash and people are actually paying their federal and state taxes and whatever else they have to pay. One last question for the both of you. We've heard that there is legislation in Congress that is under consideration. Can you tell us a little bit about it and what the chances of passage are?

Jean Gonnell:

Well, starting with the SAFE Banking Act, honestly been in the cannabis industry for a very long time, and I think everybody is hopeful, but frankly not holding our breath. This has been going on for a very long time, and ultimately, the SAFE Banking Act would allow licensees in the marijuana industry, access to bank accounts, deposit accounts, insurance, and all financial services. Because right now, if you walk into a dispensary, you will have to go to an ATM that's on a different part of the piece of property where the dispensary is, pull cash out of an ATM. Those are the types of hurdles the customers have to go through, and the types of hurdles that licensees have to deal with to merely sell products. And so the SAFE Banking Act would get rid of those extra hurdles on some level by allowing banks to allow deposit accounts.

It also potentially will adjust and change the issues pertaining to taxation when it comes to 280E, a different podcast for a different day. But there is some potentially far-reaching positive effects for the SAFER Banking Act, albeit I don't see it happening within the next year, but I don't have a crystal ball. One can hope.

Agustin Rodriguez

Yeah, and I'll just add there's more than a couple of others out there, but just a couple that maybe are worth raising. One is called the MORE Act, the Marijuana Opportunity Reinvestment Expungement Act, and this is one that would go further than the SAFER Banking Act. This is only in the House of Representatives now, but it would be criminalized to schedule cannabis from the CSA, provide for reinvestment in certain persons, adversely impacted by the war on drugs and provide for expungement of certain cannabis offenses, among other things, does not appear this has been considered in the Senate as yet.

The other legislation that's probably worth mentioning is a more comprehensive proposal that was proposed last year by US Senate Majority Leader Chuck Schumer. He's supported by Cory Booker, Ron Wyden, and this is the Cannabis Administration and Opportunity Act, the CAO, if you will. This act removes cannabis from Schedule 1 of the CSA, enshrines the current state cannabis licensing regimes, but introduces additional federal permitting of cannabis wholesalers. Regulatory responsibility for cannabis control, the federal level would be transferred from the DEA to the Alcohol and Tobacco Tax and Trade Bureau, also known as the TTB, and there'd be responsibility with the Bureau of Alcohol, Tobacco, Firearms and Explosives, otherwise referred to as ATF. This is another piece of legislation that does not have sufficient support in Congress to pass, but it is worth noting given it's come from the Senate Majority Leader.

Keith Barnett:

Thanks, Augustine. This has all been extremely informative and very helpful for our listeners. So Jean and Augustine, thank you very much for joining us today. Something tells me you're going to get a lot of follow-up questions, but also thank you to our audience for listening to today's episode. And don't forget to visit our blog, ConsumerFinancialServicesLawMonitor.com and subscribe so you can get the latest updates. Please make sure to also subscribe to this podcast via Apple Podcasts, Google Play, Stitcher, or whatever platform you use, and we look forward to the next time. Thank you.

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