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Securities and Marijuana: A Broker/Dealer's Guide to Navigating through the Rules and Regulations Related to the Cannabis Industry

By Christopher P. Parrington

As of today, there are 23 states, plus the District of Columbia, that have legalized the cultivation, distribution and consumption of medical marijuana. There are four states that have legalized recreational marijuana, namely Colorado, Washington, Oregon and Alaska. In November 2016, 20 more states will have initiatives on their ballots related to the legalization of marijuana, including California, where voters will decide whether or not to expand their marijuana industry to recreational consumption. Recent polling suggests that the approval rate for recreational marijuana in California is more than 60%, suggesting that it is inevitable that recreational marijuana will soon become legal in the state with the largest population in the U.S.[1]

In 2012, the voters of Colorado passed an initiative that allowed for the cultivation, distribution and consumption of recreational marijuana starting in 2014. In 2015, marijuana sales exceeded $996 Million in Colorado.[2] In the 4th quarter of 2015, Colorado marijuana sales exceeded $100 Million a month.[3] During the same year, Washington had marijuana sales in excess of $486 Million, with more than $200 Million in sales reported through March 2016.[4] According to a recent report issued by Bank of America Merrill Lynch, at the current growth rate of the state-legal cannabis industry, marijuana sales could exceed $35 Billion by 2020.[5] Despite less than 50% of the states currently allowing for the sale of medical marijuana, and less than 10% of the states allowing for the sale of recreational marijuana, the state-legal cannabis is already a $1.0 Billion plus industry.

According to FINRA, there are more than 641,000 registered brokers doing business throughout the United States.[6] There are also more than 4,000 broker/dealer firms operating in the same market.[7] There are currently 76 marijuana-related businesses trading securities according to the Marijuana Index.[8] At the end of 2014, the Securities and Exchange Commission approved registration of shares for Terra Tech Corp., which according to its registration statement, was seeking to raise funds, in part, to finance "three majority-owned subsidiaries for the purposes of cultivation or production of medical marijuana and/or operation of dispensary facilities in various locations in Nevada."[9] Securities and marijuana have already crossed paths and will only become more intertwined.

Even though the movement to legalize marijuana has great momentum nationwide, those that own and operate marijuana-related businesses have and continue to face great challenges. Arguably the single largest challenge for the cannabis industry is what to do with their money – very few banks nationwide are willing to do business with the cannabis industry given the number of unsettled legal and regulatory issues. Given the current and potential sales figures, more and more people are entering the cannabis industry every day. Many of those business owners will be in desperate need of something to do with their money and are already turning to brokers and their firms for investment opportunities as a solution. Furthermore, many of the marijuana-related businesses will be in need of assistance with their fundraising efforts to expand their operations. Therefore, although some brokers and their firms are already working with the cannabis industry, it is inevitable that as the industry grows, so too will the number of brokers and firms working with marijuana-related businesses and their owners. However, navigating through the rules and regulations related to the cannabis industry and its ancillary businesses is easier said than done, and

1. http://mjbizdaily.com/chart-week-support-recreational-marijuana-key-states/.
2. http://www.thecannabist.co/2016/02/09/colorado-marijuana-sales-2015-reach-996-million/47886/.
3. *Id.*
4. http://www.502data.com/.
5. http://cloud.chambermaster.com/userfiles/UserFiles/chambers/2058/File/Merrill-LynchCannabisReport12.15.pdf, at pg. 39.
6. https://www.finra.org/newsroom/statistics.
7. *Id.*
8. http://marijuanaindex.com/stock-quotes/marijuana-index-us-reporting/.
9. https://www.sec.gov/Archives/edgar/data/1451512/000147793214007296/trtc_s1.htm, at pg. 7.

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the potential repercussions of doing it wrong are too great to ignore.

Cannabis Conflict between State and Federal Law

Although the cultivation, distribution and consumption of marijuana are legal in some form (medical or recreational) in 23 states and the District of Columbia, it is still illegal under federal law. Under the Controlled Substance Act, it is illegal to distribute a Schedule I controlled substance.[10] Marijuana is classified as a Schedule I drug under the Controlled Substance Act.[11] Therefore, regardless of whether marijuana-related businesses are compliant with their respective state laws, they are in violation of the federal law if they are growing and selling marijuana.

Federal anti-money laundering laws provide for criminal liability against anyone who engages in a financial transaction knowing that the property involved represents proceeds from unlawful activity, including the sale of marijuana in violation of the Controlled Substance Act.[12] Financial institutions are required to report suspicious transactions relevant to a possible violation of the law, and the failure to report such suspicious transactions could result in criminal liability for those financial institutions and their directors, officers, employees and agents, under the Bank Secrecy Act.[13] Broker/dealer firms fall within the definition of a "financial institution" under the Bank Secrecy Act.[14] Therefore, broker/dealer firms and their registered representatives must be careful to delicately navigate through the relevant rules, regulations, guidance and laws when deciding to do business with the cannabis industry.

In October 2009, after the first states legalized medical marijuana, David W. Ogden, Deputy Attorney General, issued a memorandum to the U.S. Attorneys, providing guidance on investigations and prosecutions of Controlled Substance Act violations in states authorizing the medical use of marijuana (the "Ogden Memo").[15] According to the Ogden Memo, "[t]he Department of Justice is committed to the enforcement of the Controlled Substance Act in all states [because] Congress has determined that marijuana is a dangerous drug, and the illegal distribution and sale of marijuana is a serious crime."[16] However, the Ogden Memo further provides that "[t]he Department [of Justice] is also committed to making efficient and rational use of its limited investigative and prosecutorial resources."[17] Although the U.S. Attorneys are vested with "'plenary authority with regard to federal criminal matters' within their districts . . . [t]his authority should, of course, be exercised consistent with Department [of Justice] priorities and guidance."[18] As a result, pursuit of the Department of Justice's priority of prosecuting violations of the Controlled substance Act "should not focus federal resources in States on individuals whose actions are in ***clear and unambiguous compliance*** with existing state laws providing for the medical use of marijuana."[19]

In August 2013, following Colorado and Washington voters passing initiatives legalizing the recreational use of marijuana, James M. Cole, Deputy Attorney General, issued another memo to the U.S. Attorneys (the "First Cole Memo").[20] Although the First Cole Memo reiterated the guidance set forth in the Ogden Memo, it went a step further and identified eight (8) marijuana-related enforcement priorities of the Department of Justice.[21] Specifically, those enforcement priorities include preventing:

- The distribution of marijuana to minors;
- Revenue from the sale of marijuana from going to criminal enterprises, gangs and cartels;
- The diversion of marijuana from states where it is legal under state law in some form to other states;
- State-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs and other illegal activity;
- Violence and the use of firearms in the cultivation and distribution of marijuana;
- Drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- The growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Marijuana possession or use on federal property.[22]

According to the First Cole Memo, "prosecutors should continue to review marijuana cases on a case-by-case basis, and weigh all available information and evidence, including, but not limited to, whether the operation is demonstrably in compliance with a strong and effective state regulatory system."[23] However, the primary question in all cases should be "whether the conduct at issue implicates one or more of the enforcement priorities listed above."[24] Even though the First Cole Memo is intended to provide guidance as to the exercise of investigative and prosecution discretion, it clearly states that it "does not alter in any way the Department [of Justice]'s authority to enforce federal law" and neither the guidance, nor any state or local laws, provide a defense to a violation of federal law, including violation of the Controlled Substance Act.[25]

10. Controlled Substance Act § 828(a).
11. Controlled Substance Act § 812.
12. 18 U.S.C. § 1956(a)(1).
13. 31 U.S.C. § 5318(g).
14. 31 U.S.C. § 5312(a)(2)(H).
15. Ogden Memo (Oct. 19, 2009), https://www.justice.gov/opa/blog/memorandum-selected-united-state-attorneys-investigations-and-prosecutions-states.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.* (emphasis added).
20. Cole Memo (August 29, 2013), https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.
21. *Id.*
22. *Id.* at pgs. 1-2.
23. *Id.* at pg. 3.
24. *Id.*
25.*Id.* at pg. 4.

In January 2014, Colorado and Washington experienced their first sales of recreational marijuana. Almost immediately, it became clear that one of the more significant issues facing marijuana-related businesses was the lack of banking services available in light of the fact that banks doing business with the cannabis industry are in violation of federal law. As a result, on February 14, 2014, the Financial Crimes Enforcement Network ("FinCEN") issued a memorandum providing guidance to clarify Bank Secrecy Act expectations for financial institutions seeking to provide services to marijuana-related businesses (the "FinCEN Guidance").[26] The FinCEN Guidance "clarifies how financial institutions can provide services to marijuana-related businesses consistent with their [Bank Secrecy Act] obligations."[27] In issuing the FinCEN Guidance, it was FinCEN's hope that it would "enhance the availability of financial services for, and the financial transparency of, marijuana-related businesses."[28]

According to the FinCEN Guidance, "the decision to open, close or refuse any particular account or relationship should be made by each financial institution based on a number of factors specific to that institution," including the particular business objectives of the financial institution, an evaluation of the risks associated with offering a particular product or service, and the financial institution's capacity to manage those risks effectively."[29] In evaluating these factors, "[t]horough customer due diligence is a critical aspect of making this assessment."[30] In performing this due diligence, the FinCEN Guidance articulates that a financial institution's due diligence procedures should include, at a minimum:

- Verifying with appropriate state authorities whether the business is duly licensed and registered;
- Reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business;
- Requesting available information about the business and related parties from state-licensing and enforcement authorities;
- Developing an understanding of the normal and expected activity for the business;
- Ongoing monitoring of publicly available sources for adverse information about the business and related parties;
- Ongoing monitoring for suspicious activity, including red flags described in the FinCEN Guidance; and
- Refreshing information obtained as part of a customer due diligence on a periodic basis and in accordance with the associated risk.[31]

26. FinCEN Guidance Memo (Feb. 14, 2014), https://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf.
27. *Id.* at pg. 1.
28. *Id.*
29. *Id.* at pg. 2.
30. *Id.*
31. *Id.* at pgs. 2-3.

The FinCEN Guidance goes on to identify various red flags that the marijuana-related business may be engaged in activity that implicates one of the First Cole Memo priorities or violates state law, such as: the business receives substantially more revenue than reasonably expected or more than its local competitors; the business is depositing more cash than is commensurate with the amount reported for federal and state tax purposes; rapid movement of funds in and out of the account; deposits by third-parties with no apparent connection to the accountholder; commingling of funds with the business owner or manager's personal accounts; financial statements are inconsistent with the actual account activity; the business is unable to demonstrate the legitimate source of outside investments; the business uses a non-descript name such as "consulting," "holding," or "management"; the owners or managers of the business reside outside the state in which the business is located; the business is purporting to be a "non-profit"[32] despite being engaged in commercial activity.[33]

Regardless of the type of business (marijuana-related or not), a financial institution is required to file a Suspicious Activity Report ("SAR") if it knows, suspects or has reason to suspect that a transaction conducted through the financial institution involves funds derived from illegal activity.[34] Given that the cultivation and sale of marijuana is illegal under the Controlled Substance Act, financial institutions doing business with the cannabis industry must file SARs under federal law. According to the FinCEN Guidance, however, SAR filing for marijuana-related businesses shall receive special attention. For example, if, based upon its customer due diligence, a financial institution believes that a marijuana-related business does not implicate one of the First Cole Memo priorities and does not violate applicable state law, then the financial institution should file a "Marijuana Limited" SAR[35] containing specific information about the business.[36] If, after due diligence, the financial institution believes that the marijuana-related business implicates one of the First Cole Memo priorities, then it should file a "Marijuana Priority" SAR.[37] If the financial institution deems it necessary to terminate a relationship with a marijuana-related business due to maintain its anti-money laundering program, it should file a "Marijuana Termination" SAR.

On the same day that the FinCEN Guidance was issued, James Cole issued a second memo providing guidance on the impact that the First Cole Memo would have on certain financial crimes for which marijuana-related conduct is a predicate (the "Second Cole Memo").[38] According to

32. Under current California law, those engaged in the cultivation or distribution of medical marijuana are not authorized to do so "for profit." CA Code § 11362.765. Therefore, this red flag factor is even more significant for those financial institutions doing business with medical marijuana-related businesses in California.
33. *Id.* at pgs. 6-7
34. a 31 CFR § 1020.320.
35. The FinCEN Guidance further provides that a financial institution should follow FinCEN's previous guidance on the filing of continuing activity reports for the same activity reported on the "Marijuana Limited" SAR, in addition to performing ongoing due diligence for red flags of changes that may implicate one of the First Cole Memo priorities. FinCEN Guidance at pg. 4.
36. FinCEN Guidance at pgs. 3-4.
37. *Id.* at pg. 4.
38. Second Cole Memo (Feb. 14, 2014), https://www.justice.gov/sites/default/files/usao-wdwa/legacy/2014/02/14/DAG%20Memo%20-%20Guidance%20Regarding%20Marijuana%20Related%20Financial%20Crimes%202%2014%2014%20%282%29.pdf.

the Second Cole Memo, investigations and prosecutions of violations of the Bank Secrecy Act with respect to marijuana-related businesses should be subject to the same consideration and prioritization of investigations and prosecutions of violations of the Controlled Substance Act.[39] As such, the Second Cole Memo reiterates the importance of a financial institution performing adequate due diligence on its customers to ensure compliance with the First Cole Memo priorities and the applicable state laws, but also provides that "it is essential that financial institutions adhere to FinCEN's guidance."[40] Similar to the First Cole Memo, however, the Second Cole Memo reminds financial institutions that it is merely intended as a guide to the exercise of investigative and prosecutorial discretion by U.S. Attorneys, and that nothing in it provides a legal defense or restricts the Department of Justice's authority to enforce federal law.[41]

So what does all this mean?

Despite the direction set forth in the Cole Memos and the FinCEN Guidance, most financial institutions are still refraining from servicing marijuana-related businesses. However, there are some financial institutions that have elected to pave the way for doing business with the cannabis industry. According to FinCEN, from February 2014 through January 2015, there were 3,157 marijuana-related SARs filings.[42] Of these filings, 1,736 were "Marijuana Limited" SARs in 25 different states, which mean that there were at least 1,736 active accounts at financial institutions doing business with marijuana-related businesses.[43] During the reported time period, 37 of the financial institutions were broker/dealer firms that reported filing marijuana-related SARs.[44] Although the number of broker/dealer firms that filed marijuana-related SARs is less than 1% of the total number of broker/dealer firms registered with FINRA, it is clear that at least some brokers and their firms are actively doing business with the cannabis industry today.

Under the guidance set forth by the Cole Memos and the FinCEN Guidance, those brokers and firms doing business with the cannabis industry have a special set of rules to follow. For example, FINRA Rule 2111 requires that FINRA members have a reasonable basis to believe that a recommended transaction and investment strategy is suitable for the customer, based upon information obtained about the customer through reasonable due diligence.[45] In the event the customer is engaged in a marijuana-related business, the Cole Memos and FinCEN Guidance require that the FINRA member not only determine suitability for the particular transaction or strategy, but likewise determine if the source of the funds being invested are from a marijuana-related business that is in compliance with the First Cole Memo priorities and applicable state law, for the purpose of filing the appropriate marijuana-related SAR. These enhanced obligations would apply to any broker/dealer firm recommending an investment transaction or strategy utilizing funds generated from the operation of a marijuana-related business.

Not only must broker/dealer firms be knowledgeable on the regulatory environment related to the cannabis industry in order to adequately know their customers and determine the appropriate SAR filing, but many broker/dealers will likely be presented with cannabis-related investment opportunities to present to their clients. For example, not only must a FINRA member determine if the transaction is suitable for the customer based upon the customer's investment profile information, but the FINRA member must also perform due diligence on the sponsor of the investment product.[46] When the investment product is marijuana-related, the due diligence must be enhanced to include an investigation and assessment of whether the business seeking investors is compliant with the First Cole Memo priorities and applicable state law. Furthermore, it will be important to ensure that FINRA members recommending investments into marijuana-related businesses adequately identify and disclose the risks associated with investing in the cannabis industry, including the risks of prosecution for violation of the Controlled Substance Act. This is especially true given FINRA's concerns about investing in the cannabis industry as set forth in FINRA's investor alert in May 2014.[47]

The final area in which the cannabis industry could be relevant to a broker/dealer firm pertains to registered brokers seeking approval to be involved in marijuana-related business as outside business activities ("OBA"). For example, FINRA Rule 3270 requires advance notice to a broker/dealer firm before a FINRA member is engaged in a business activity outside the scope of his or her member firm.[48] Upon receipt of notice of an OBA, the broker/dealer firm is required to evaluate certain considerations, which require the firm to have an adequate understanding of the proposed activity including whether the activity is compliant with the First Cole Memo priorities and applicable state law when it is marijuana-related, especially given the obligations imposed upon the member firm as a financial institution governed by the Bank Secrecy Act.[49] Furthermore, where an OBA is approved, then the member firm will need to ensure that it has the proper procedures in place to monitor the activity for changes that may raise red flags of violations of the First Cole Memo priorities or applicable state law after the activity is approved.

What does the future hold?

Although the Cole Memos and FinCEN Guidance provide guidance for brokers and their firms doing business with the cannabis industry, at the end of the day, those documents are just what they say – guidance on how to best avoid being the subject of an investigation or prosecution for violating federal law. As the Cole Memos and FinCEN Guidance make clear, even 100% compliance does not guarantee a lack of investigation or prosecution by the

39. *Id.* at pg. 2.
40. *Id.* at pg. 3.
41. *Id.*
42. http://securitiesanalytics.com/marijuana_SARs.
43. *Id.*
44. *Id.*
45. FINRA Rule 2111(a).
46. *See* FINRA Notice to Member 10-22.
47. *See* www.finra.org/investors/alerts/marijuana-stock-scams.
48. FINRA Rule 3270.
49. FINRA Rule 3270, Supp. Material .01.

Department of Justice. This dilemma has been well-recognized by Congress and the United States District Courts, who on almost a weekly basis, attempt to resolve this conflict are being considered.

At the end of 2015, Congress voted to approve an extension of Section 538 of the 2015 Appropriations Act, into 2016.[50] Known as the Rohrbacher-Farr Amendment, Section 538 provides that none of the funds made available to the Department of Justice under the appropriations act may be used "to prevent [the states[51]] from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana."[52] Thereafter, the applicability of the Rohrbacher-Farr Amendment was challenged in the U.S. District Courts for the Northern District of California, in the matter of United States of America v. Marin Alliance for Medical Marijuana, et al. (the "MAMM Case").[53] In the MAMM Case, the Court was asked by the Marin Alliance for Medical Marijuana ("MAMM"), to dissolve a previously entered permanent injunction on the grounds that the Department of Justice was prohibited from expending funds to enforce the injunction under the Rohrbacher-Farr Amendment.[54] Although the Court refused to dissolve the injunction in the MAMM Case, it made clear that "[t]he plain reading of the text of Section 538 forbids the Department of Justice from enforcing this injunction against MAMM to the extent that MAMM operates in compliance with California law."[55] The Court went on to state that "Congress dictated in Section 538 that it intended to prohibit the Department of Justice from expending in connection with the enforcement of any law that interferes with California's ability to [implement its own State law that authorizes the use, distribution, possession, or cultivation of medical marijuana.']"[56]

As a result, the Court in the MAMM Case concluded that "as long as Congress precludes the Department of Justice from expending funds in the manner proscribed by Section 538, the permanent injunction will only be enforced against MAMM insofar as that organization is in violation of California 'State laws that authorize the use, distribution, possession, or cultivation of medical marijuana.'"[57] In light of this decision, financial institutions servicing the medical marijuana industry now have an argument against prosecution so long as their customers are acting in compliance with applicable state law. Such an argument further raises the importance of performing adequate due diligence when a broker/dealer firm elects to do business with the cannabis industry.

Not only has Congress enacted the Rohrbacher-Farr Amendment, but there are currently several bills on the floors of the House of Representatives and the Senate designed to resolve the challenges faced by financial institutions seeking to provide services to the cannabis industry. For example, there is currently a proposed bill being considered by the Senate, which would provide that enforcement of the Controlled Substance Act relating to marijuana "shall not apply to any person acting in compliance with state law relating to . . . medical marijuana."[58] Likewise, there are companion bills currently being considered by the House and the Senate, referred to as the "Marijuana Businesses Access to Banking Act of 2015," which would provide a safe harbor for "depository institutions providing financial services to marijuana-related businesses" with respect to regulatory action "prohibiting, penalizing, or otherwise discouraging a depository institution from offering such services."[59] Although the Marijuana Businesses Access to Banking Act of 2015 has a long way to go before there is a resolution to the financial services crises faced by the cannabis industry, it currently has 33 co-sponsors in the House and 11 co-sponsors in the Senate, including co-sponsors from states other than Colorado, Washington, Oregon and Alaska, which is a sign of encouragement that a resolution is on the horizon.

The movement to legalize marijuana is constantly evolving, often on a daily basis. As more states vote to approve legalized marijuana (whether in the medical or recreational form), the need for services from ancillary businesses will likewise grow. Although the cannabis industry is and will continue to be in demand for the services of all kinds of ancillary businesses, the most important will be the services provided by financial institutions. Although some broker/dealer firms are currently doing business with the cannabis industry, the financial institutions at the forefront of this issue today are banks. Given, however, that banks and broker/dealer firms are all financial institutions as defined by the Bank Secrecy Act, developments for the banking industry today will have a significant impact on the relationship between brokers, broker/dealer firms and the cannabis industry tomorrow. And although it is still unlawful for brokers and broker/dealer firms to do business with the cannabis industry under federal law, the Department of Justice and FinCEN have provided guidance on how to best avoid the potential for investigation and prosecution of those doing business with the cannabis industry.

Currently there are a lot of questions that need to be answered for financial institutions desiring to service the cannabis industry, but as the movement to legalize marijuana grows nationally, a lot of those questions should be answered at the same time. Until then, adherence to the guidance provided by the Department of Justice and FinCEN is the best that a financial institution can do to engage in a business that is still illegal under federal law. ★

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50. 2016 Appropriations Act, Pub. L. 114-53, § 103, 129 Stat. 502 (2015).
51. Those states identified in the Rohrabacher-Farr Amendment are the states with legalized medical marijuana.
52. *Id.* (footnote added).
53. Court File No. C 98-00086 CRB.
54. *See* Order Re Motion to Dissolve Permanent Injunction (October 19, 2015), U.S. Dist. Ct. File No. C 98-00086 CRB.
55. *Id.* at pg. 7.
56. *Id.*
57. *Id.* at pg. 13 (citing 2015 Appropriations Act § 538).
58. *See* Compassionate Access, Research Expansion, and Respect States Act of 2015, Senate Bill S.683.
59. *See* Marijuana Businesses Access to Banking Act of 2015, House Bill H.R. 2076 and Senate Bill S.1726.