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in the anti-money laundering field

DEEP INTO THE WEEDS: CANNABIS AND COMPLIANCE



One of the few highlights in the U.S. economy in 2020 was the skyrocketing sales of legal cannabis, with the average store revenue increasing by 52% to 130% across the nation¹ despite the industry's unsure regulatory footing. Cannabis that is not classified as hemp is still outlawed by the Controlled Substances Act² (CSA), and yet it has been legalized in some form (i.e., for medical and/or recreational use) in 45 states and the District of Columbia.³ Joe Biden's victory in the U.S. presidential election could mark the needed boost toward national legalization of cannabis. President Biden has said he would support deferral decriminalization of the drug.⁴ Cannabis lobbyists in Capitol Hill expect some form of safe banking to pass with a stimulus package during the Biden administration. On May 21, 2021, it was reported that House Judiciary Committee Chairman Representative Jerrold Nadler (D-NY) planned to reintroduce The Marijuana Opportunity, Reinvestment and Expungement (MORE) Act as early as the week of May 24, 2021.⁵ During the recent general election, four more states voted to legalize recreational cannabis, propelling momentum. In addition, voters in one state backed the creation of a medical cannabis program.⁶ Although these tilt the scale favorably, the Biden administration needs to address the current legal stand on cannabis, which remains unstable, as evidenced by the Justice Department's actions.

Under President Obama, the Cole Memo represented a shift in the federal government's approach to deprioritize the use of funds to enforce cannabis prohibition under the CSA, and pivoted toward a more laissez-faire, hands-off approach while keeping the prohibition intact.⁷ Early in the Trump administration, former U.S. Attorney General Jeff Sessions rescinded the Cole Memo. Yet, the Financial Crimes Enforcement Network⁸ (FinCEN) continues to rely on it for guidance, supported by updates to the suspicious activity report (SAR) filing process explicitly for banks serving marijuana-related businesses (MRBs) that mirrored the eight priority enforcement factors contained in the Cole Memo.⁹ Financial institutions (FIs) that may be knowingly or unknowingly dealing with cannabis companies must have airtight know your customer (KYC) processes in place to withstand regulatory scrutiny and to be positioned for a possible change in legal status that could occur in the near future.

Uncertain times call for scrutiny of compliance programs

Notwithstanding the misaligned legal frameworks (state vs. federal), the one thing FIs need to be clear on is their risk tolerance. On this question, management has basically three choices: 1) zero tolerance; 2) open to the possibility, contingent to federal legalization; or 3) open to lending now. In addition, management needs to revisit its compliance program to ensure it remains compliant with federal law today and, equally as important, that the KYC program is consistent.

Are you exposed?

Irrespective of risk tolerance, proactively assessing the compliance program minimizes the chances of serving as a conduit for illegal activity. It enables insight to implement controls tailored to the client, geography and product type. It also empowers personnel as gatekeepers of the firm to detect bad actors attempting to infiltrate the firm. Stakeholders on the front lines of defense should consider the following list of KYC elements, where the practice should be written into policies and procedures:

- For new clients, was a site visit made by the relationship manager? Does the manager know what to look for to assure compliance?
- Does the documentation align with the business (i.e., address, state of operations/incorporation, beneficial owners/signers)? This includes whether the business is running true to what was stated in its cannabis license application.¹⁰
- Are the offered products/services clear (e.g., delivery channels, markets served, touching the plant vs. not)? Are the products being tracked and reported to the state (i.e., using track and trace systems)?

- What payment methods are accepted and are they lawful? Are credit card transactions being miscoded to hide cannabis sales? Is an offshore FI with a dubious reputation being used? Are there sufficiently rigorous and documented cash handling policies and procedures?
- Are customers' identifications rigorously checked to prove the legal age of the buyer?
- Does the business deal with third parties that are vetted? Can it transact business on behalf of third parties? If yes, what documentation does it collect from its customer base?
- Does the business maintain a website? If not, how does it market its business?
- Were any accounts opened conditionally that have not been satisfied but continue to have an active status?
- Did screenings return any potential adverse media? If so, were the proper channels of escalations taken to approve account opening?
- For existing clients, was the KYC form reassessed throughout the life of the relationship to ensure that all the material information remained accurate and that the client was properly risk rated?¹¹
- Have accounts with a nexus to one another been properly identified? If yes, does the business structure and type make sense according to what was disclosed during account opening?
- For MRB accounts operating in designated states where cannabis is legal, does the business activity align with the enterprise risk tolerance and local law¹² (e.g., Canada permits business dealings with Cuba whereas the U.S. does not)? Have all observations been properly documented and has it been ensured that only legitimately sourced funds are being deposited into the account and that no intra-account funds transfers between different jurisdictions have been allowed?¹³
- Have dormant accounts with negative or no balances for six months or more been revisited and discussed?
- Have noncompliant accounts been flagged and tracked appropriately?
- How does the customer enforce compliance with applicable laws? How do they document such?
- Does the KYC program rely heavily on the branch and/or the relationship manager to conduct customer onboarding digitally?

It is not uncommon for FIs to get into the habit of modifying the living document, but these fail to remove steps that no longer apply to the overall operations. As a best practice, the documentation process should capture updates to policies and procedures.

Of course, this becomes even more perplexing to FIs that find themselves in states where cannabis has been legalized for either medicinal or recreational use. With \$12.2 billion in revenue generated in the U.S. in 2019,¹⁴ MRBs have become increasingly more enticing financially across states that have enabled their operations, while FIs are left considering where they stand from a risk tolerance optic.

You discovered you are lending to an MRB, now what?

First things first: address the risk. Appropriate controls of the firm's risk exposure to an MRB are critical to ensure that the compliance program accounts for the inherent and residual risk to its product, geography and customer demographics. An FI may have initially opted to do business with that entity without knowing it was an MRB but after proper identification and further assessment of third-party exposure, coupled with insight to markets served indirectly, it may reconsider closing the account. The following are critical factors to assess:

- Ensure that the client aligns with the established risk tolerance and board directives.
- Assess what suite of services are extended to this MRB and whether sufficient controls are in place.

- From a document retention optic, ensure that all required paperwork is on file.
- Confirm that policies and procedures reflect this client type.
- Review the current SAR filing obligations and its process. For an MRB banking client, a SAR must be filed every 90 days.
- Calibrate the existing surveillance monitoring platform to include this client type.
- Assess whether any prior alert or investigation was flagged by surveillance systems. If yes, what steps/decisions were reached and was the action warranted?

Whether an FI inherited a deficient program, has been busy trying to enhance the existing one or lacks the budget to address vulnerabilities, regulatory expectations do not change. Understanding how deep into the weeds the firm is (pun intended) can be the difference between continued operations and a sanctioned program.

APPROPRIATE CONTROLS OF THE FIRM'S RISK EXPOSURE TO AN MRB ARE CRITICAL TO ENSURE THAT THE COMPLIANCE PROGRAM ACCOUNTS FOR THE INHERENT AND RESIDUAL RISK TO ITS PRODUCT, GEOGRAPHY AND CUSTOMER DEMOGRAPHICS

IT IS CRITICAL THAT THE TRANSACTION MONITORING PROGRAM IN PLACE TIES BACK TO THE COMPOSITION OF THE FIRM'S CLIENT BASE

A key point to consider is the fact that the CSA is not extraterritorial.¹⁵ This means that if the activity is legal in the country in which it is taking place, then any proceeds from that activity generally would not be illegal under U.S. anti-money laundering laws. This poses a significant risk to U.S.-based FIs that potentially house a client involved in non-U.S. cannabis-related business abroad and heightens the onus on domestic FIs to know who they conduct business with, directly and indirectly, as mandated by the USA PATRIOT Act.

Failure to do so not only exposes the FIs to financial and accounting risks¹⁶ but also to the following legal, compliance and operational outcomes:

- Doing business with front or shell companies whose true identities and activities are unknown
- Loss of bank charter/license for violation of federal law
- Increased regulatory scrutiny and potential monetary fines¹⁷ and/or branch closures
- Legal liabilities due to deposits transferred to other FIs

- Holding/freezing deposits derived from potentially illegitimate activity
- Loss of Federal Deposit Insurance Corporation (FDIC) coverage as a result of illegal activity
- Facilitating transactions for non-U.S.-related entities in jurisdictions where cannabis is illegal
- Improper classification of clients involved with hemp and insufficient understanding of their products
- Increased susceptibility to robberies, kidnappings and cyberattacks
- Stock devaluation and/or reputational damage

Local businesses disguising their true operations also represent a KYC risk. Failure to identify them can bring into question the integrity of the surveillance program of the FI and ultimately, its data infrastructure.

A gap has been identified in KYC while rendering services to an MRB, what is next?

It is critical that the transaction monitoring program in place ties back to the composition of the firm's client base. Cannabis companies that operate in multiple states (known as multi-state operators) can further complicate this surveillance. The Schedule I classification under the CSA strictly prohibits any FI from knowingly conducting a financial transaction involving the proceeds of a specified unlawful activity (even if the activity occurred in the state where it is deemed legal). Intentionally looking the other way on any finding can still hold an FI liable under "willful blindness." Unfortunately, being intentionally deceived in facilitating financial transactions for a client is not a defense against liability, as this only redirects the focus onto the firm's KYC and customer due diligence (CDD) programs. Regulators will not forgive a lax compliance program that failed to identify such a business, which by default, adds exposure to the firm and its client base in terms of financial liability.

The following are potential red flags to consider:


- A complex corporate structure often with a generic-sounding parent company listed in Delaware or other states where beneficial ownership is not listed
- Excessive cash deposits or withdrawals within a short period of time
- Third-party cash deposits with no apparent nexus to the account holder
- Payroll-related transactions that appear unusual due to the timing and/or amount, given the known number of employees
- Significantly more revenue received into the account than what was disclosed at client onboarding or on its KYC form
- Transactions involving companies related to hydroponics or other plant cultivation activity when the focus is not involved in a related business
- Activity for client type is significantly distinct from that of another client in the same industry and/or jurisdiction
- Multiple accounts maintained by a new or existing client where operations in a state that legalized cannabis use reflect in many cash deposits
- Incoming or outgoing funds transfers involving other MRBs
- Revamping of surveillance rules to ensure monitoring is inclusive of MRBs and/or is involved in hemp

Conclusion

The cannabis industry is far from mature. Its legal gray area between the state and federal level makes it a challenge to bank. As of December 31, 2020, FinCEN had received a total of 170,975 SARs using key phrases associated with MRBs.¹⁸ FIs may be submitting defensive filings¹⁹ to avoid banking violations that may result from an exposed relationship prior to a full

vetting of financial transactions that may prove helpful to law enforcement.

Currently, the consequences appear to outweigh the rewards. FIs that take up this challenge must have a sound KYC program that not only demonstrates readiness to mitigate unwarranted risk against MRBs, but also puts in place the infrastructure needed to satisfy a new risk appetite without delay should the federal government legalize cannabis.

An enhanced compliance program signals tone from the top. Are there open lines of communication with management and ultimately the board of directors? It is important that the compliance program's policies and procedures reflect a level of transparency to the firm's governing authority. A well-run program that carefully evaluates its risk tolerance and has a sound process to develop new product offerings and controls to monitor those services stands a far greater chance at a favorable examination result than one that does not. 

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¹ Melissa Sammy, "Cannabis and COVID-19: Is it safe to light up?" *MDLinx*, April 17, 2020, [https://www.mdlinx.com/article/cannabis-and-](https://www.mdlinx.com/article/cannabis-and-covid-19-is-it-safe-to-light-up/BB8aLZnyYPYJ6fLebAC3I)

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² U.S.C. 21 § 801 *et seq.*

³ "AML Considerations for Investments in Cannabis-Related Businesses," *Practicing Law Institute*, <https://www.pli.edu/programs/aml-considerations-for-investments-in-cannabis-related-businesses>

⁴ Kyle Jaeger, "Biden Talks Marijuana Decriminalization While Trump Promotes Criminal Justice Record At Dueling Town Halls," *Marijuana Moment*, October 16, 2020, <https://www.marijuanamoment.net/biden-talks-marijuana-decriminalization-while-trump-promotes-criminal-justice-record-at-dueling-town-halls/>

⁵ Kyle Jaeger, "Key Chairman Plans To File Revised Federal Marijuana Legalization Bill In House As Early As Next Week," *Marijuana Moment*, May 21, 2021, <https://www.marijuanamoment.net/key-chairman-plans-to-file-revised-federal-marijuana-legalization-bill-in-house-as-early-as-next-week/>

⁶ Recreational: New Jersey, Arizona, Montana, and South Dakota. Medical: Mississippi. Jeremy Berke, Shayanne Gal and Yeji Jesse Lee, "Marijuana legalization is sweeping the US. See every state where cannabis is legal." *Business Insider*, April 14, 2021, <https://www.businessinsider.com/legal-marijuana-states-2018-1>.

⁷ "Guidance Regarding Marijuana Enforcement," *U.S. Department of Justice*, August 29, 2013, <https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf>

⁸ "Financial Crimes Enforcement Network," *U.S. Department of Treasury*, <https://www.treasury.gov/about/history/Pages/fincen.aspx>

⁹ "A Year After Cole Memo Rescission and Marijuana Banking Goes On," *Hypur*, <https://www.hypur.com/cole-memo-recscission-one-year-later/>

¹⁰ "Marijuana Business: Licenses, Permits, and Planning," *FindLaw*, <https://public.findlaw.com/cannabis-law/starting-a-cannabis-business/marijuana-business-licenses-permits-and-planning.html>

¹¹ FinCEN mandates that a SAR be filed every 90 days on any MRB. That requirement implies the need to check the risk exposure continually.

¹² Bani Sapra, "Canada becomes second nation in the world to legalize marijuana," *CNN*, June 20, 2018, <https://www.cnn.com/2018/06/20/health/canada-legalizes-marijuana/index.html>

¹³ In the U.S., interstate commerce is illegal and transactions cannot cross state borders. For example, if you are a California cannabis business, you cannot order supplies from Oregon.

¹⁴ "North America Cannabis Legal Market Size Projections," *Cannabis Business Plan*, <https://cannabusinessplans.com/cannabis-legal-market-size-projections/>

¹⁵ "AML Considerations for Investments in Cannabis-Related Businesses," *Practicing Law Institute*, <https://www.pli.edu/programs/aml-considerations-for-investments-in-cannabis-related-businesses>

¹⁶ Naomi Granger, "The importance of proper accounting for cannabis businesses," *Marijuana Business Daily*, April 28, 2020, <https://mjbizdaily.com/importance-proper-accounting-cannabis-businesses/>

¹⁷ Todd S. Fishman and Eugene Ingoglia, "Active U.S. Enforcement of Anti-Money Laundering Rules Continues Unabated," *Law.com*, June 3, 2020, <https://www.law.com/newyorklawjournal/2020/06/03/active-u-s-enforcement-of-anti-money-laundering-rules-continues-unabated/?sreturn=20200703003550>

¹⁸ "Marijuana Banking Update: Depository Institutions (by type) Providing Banking Services to Marijuana-Related Businesses1 (SARs filed through 31 December 2020)," *Financial Crimes Enforcement Network*, https://www.fincen.gov/sites/default/files/shared/508_299423_MJ%20Banking%20Update%201st%20QTR%20FY2021_Public_Final.pdf

¹⁹ An informal industry term referring to an FI's preference to report a SAR filing without necessarily possessing key details that could aid law enforcement in their investigative matters to combat illicit finance effectively.