AN ANALYSIS OF THE LEGALIZATION OF MARIJUANA TO FINANCIAL INSTITUTIONS

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EXECUTIVE SUMMARY

The purpose of this paper is to provide recommendations for those financial institutions that would like to participate in the marijuana industry and those financial institutions that do not want to participate in the marijuana industry. In addition, this paper analyzes the current legal and regulatory landscape related to marijuana.

The issue is that marijuana businesses are largely prohibited from accessing financial services of financial institutions. This forces marijuana businesses to conduct transactions primarily in cash, which creates an environment that is more prone to money laundering and linking cash to criminal activities remains a key challenge for law enforcement.

The root cause of the issue is that, under federal law, marijuana is illegal, so financial institutions are prohibited from serving them. Even though the Federal government does not currently enforce the federal law against financial institutions serving marijuana businesses, financial institutions are still required by the Bank Secrecy Act (BSA) to file suspicious activity reports (SARs) for any potential suspicious activity, including marijuana activity. Although marijuana is legal for several states, marijuana is prohibited under the federal law. Therefore, any marijuana transactions processed by financial institutions are inherently suspicious.

The Department of Justice (DOJ) and the Financial Crimes Enforcement Network (FinCEN) issued guidance in February 2014 regarding the clear contradiction between federal law and state law. The DOJ Guidance and FinCEN Guidance outline expectations for financial institutions involved in the marijuana industry, and note that even though federal prosecutors should prioritize the degree of the marijuana offense, the financial institutions are still at risk for potential federal prosecution. This evidences the marijuana industry is fraught with considerable risk and compliance burdens.

Financial institutions that provide financial services to marijuana business can mitigate their anti-money laundering (AML) risks by ensuring their AML program meets or exceeds the expectations set forth in the DOJ Guidance and FinCEN Guidance. Specifically, financial institutions must first determine the risk exposure through an AML Risk Assessment and determine if the risk is aligned with its overall risk appetite. This will determine if the financial institution should enter the marijuana industry. In addition, financial institutions must perform adequate due diligence to ensure that marijuana businesses are legal under state law and to understand the expected activity, including anticipated revenues and movements of funds. Financial institutions must also implement red flags to identify potential suspicious activity during account opening and for the duration of the relationship. Furthermore, financial institutions must have appropriate transaction monitoring rules in place to identify potential suspicious activity and to determine if a marijuana-related SAR should be filed.

In summary, financial institutions considering participating in the marijuana industry will need to accept the risk of potential federal prosecution and increased regulatory scrutiny. Since the federal government acknowledged the conflicting legal nature of the marijuana industry in the DOJ Guidance and FinCEN Guidance, financial institutions still remain hesitant to provide financial services. Nonetheless, the degree of risk can be reduced through AML Programs that adequately reflect the behaviors of the marijuana industry.
INTRODUCTION

The regulation of marijuana has undergone many changes throughout the history of the U.S. The first federal law prohibiting the use and sale of marijuana was the Marijuana Tax Act of 1937.1 The Marijuana Tax Act of 1937 was a U.S. federal law that placed a tax on the sale of marijuana. It was replaced by the Controlled Substances Act (CSA) of 1970, which declared marijuana to be a Schedule I drug.2 According to the Drug Enforcement Agency, this classification means that marijuana is considered to have a high potential for abuse, no currently accepted medical use, and no accepted safe use under medical supervision in treatment.

However, states passed various legislation legalizing the sale and use of marijuana either for medical or recreational use. In 1996 California passed Proposition 215, which legalized medical marijuana.3 In response to Proposition 215, the U.S. Supreme Court ruled in 2001 in United States v. Oakland Cannabis Buyers’ Coop that federal drug laws do not permit an exception for medical marijuana.4 Furthermore, in 2005 the U.S. Supreme Court ruled in Gonzales v. Raich that even where individuals or businesses in accordance with state-approved medical marijuana programs are lawfully cultivating, possessing, or distributing medical marijuana, such persons or businesses are violating federal marijuana laws.5 In 2012, Colorado and Washington became the first states to legalize the sale and recreational use of marijuana.6

In response to state legalization of marijuana, in 2014 the federal government issued guidance to help bridge the gap between the federal law and state laws in hopes that financial institutions would provide financial services to the marijuana industry. Whereas the federal government has not prioritized the prosecution of individuals participating in the marijuana industry, the federal government maintains indirect control of the marijuana industry through the Bank Secrecy Act (BSA) of 1970, which requires the reporting of potential suspicious activity. The purpose of the BSA is for financial institutions to help the federal government prevent and detect money laundering. Therefore, the BSA requires financial institutions to file suspicious activity reports (SARs) when they suspect funds are (1) derived from an illegal activity, (2) the transaction is an attempt to disguise the source of the funds, or (3) the transaction lacks a business or apparent lawful purpose. Due to these AML regulations, most financial institutions are wary of providing financial services to the marijuana industry.7

Overall, financial institutions must first assess the risk of serving the marijuana industry despite conflict between federal and state laws and then implement appropriate mitigating controls. Regardless if the financial institution is actively involved in the marijuana industry, the AML program should still have appropriate controls in place to identify and report suspicious activity. This helps financial institutions to avoid potential BSA fines and penalties with the federal government about particular marijuana-related customers or transactions.

1 Source: 75th United States Congress. Public Law 75-238. 50 Stat. 551. (1937).
3 Source: California Health & Safety Code 11362.5.
4 Source: The Supreme Court of the Unit States: Case 532 U.S. 483 (2001).
7 Refer to the following regulations for SAR requirements: 12 CFR 208.62, 211.5(k), 211.24(f), and 225.4(f) (Federal Reserve Banks); 12 CFR 353 (Federal Deposit Insurance Corporation) (FDIC); 12 CFR 21.11; 12 CFR 163.180 (Office of the Comptroller of the Currency) (OCC); and 31 CFR 1020.320 (FinCEN); and 12 CFR 748 (National Credit Union Administration) (NCUA).
**Marijuana Laws**

Regardless of state law, the Controlled Substances Act of 1970 prohibits everyone, including financial institutions, from dealing with controlled substances. However, the federal government has articulated that if a state passes a law to decriminalize marijuana for recreational or medical use, they can do so, under the condition that a regulation system for marijuana is in place.  

**Federal Laws**

The Controlled Substances Act (CSA) of 1970 prohibits the manufacture, distribution, or possession of any controlled substance. According to the Drug Enforcement Agency (DEA), drugs, substances, and certain chemicals used to make drugs are classified into five distinct categories or schedules depending on the drug’s acceptable medical use and the drug’s abuse or dependency potential. In determining into which schedule a drug or other substance should be placed, certain factors are required to be considered.

1. The drug’s actual or relative potential for abuse
2. Scientific evidence of the drug’s pharmacological effect, if known
3. The state of current scientific knowledge regarding the substance
4. Its history and current pattern of abuse
5. The scope, duration, and significance of abuse
6. What, if any, risk there is to the public health
7. The drug’s psychic or physiological dependence liability
8. Whether the substance is an immediate precursor of a substance already controlled

Furthermore, the DEA defines the abuse rate as a determinate factor in the scheduling of the drug. For example, Schedule I drugs have a high potential for abuse and the potential to create severe psychological and/or physical dependence. Marijuana is classified as a Schedule I controlled substance, alongside drugs such as heroin and lysergic acid diethylamide (LSD). Schedule I substances are described as those that have the following findings:

1. “The drug or other substance has a high potential for abuse
2. The drug or other substance has no currently accepted medical use in treatment in the U.S.
3. There is a lack of accepted safety for use of the drug or other substance under medical supervision”

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8 This is in reference to the Cole Memo issued in August 2013 as well as DOJ Guidance and FinCEN Guidance issued in February 2014. This is discussed further in the “Impact to Financial Institutions” section.
9 The Drug Enforcement Agency website was the main source of information regarding the Controlled Substances Act (www.dea.gov) as well as “Drug Enforcement Agency. Drugs of Abuse: A DEA Resource Guide. 2015 Edition.”
10 Source: These factors are listed in Section 201 (c), [21 U.S.C. § 811 (c)] of the CSA or are also stated in the “Drug Enforcement Agency. Drugs of Abuse: A DEA Resource Guide. 2015 Edition.”
12 According to the DEA, the effect of marijuana on perception and coordination are responsible for serious impairments in learning, associative processes, and psychomotor behavior. Long term, regular use can lead to physical dependence and withdrawal following discontinuation, as well as psychic addiction or dependence. Source: Drug Enforcement Agency. Drugs of Abuse: A DEA Resource Guide. 2015 Edition.
State Laws

The legalization of marijuana in America has increased dramatically in the recent years as states have passed legislation to allow for medical or recreational marijuana use. Twenty-eight states and the District of Columbia have laws legalizing marijuana. However, these state laws vary in their criteria, such as medical conditions that qualify for medical marijuana. In addition, a number of states have decriminalized the possession of certain amounts of marijuana.\(^\text{14}\)

**STATES WHERE MARIJUANA IS LEGALIZED**

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Analysis of Federal versus State Marijuana Laws

While a federal law applies to all 50 states, state laws only apply to that specific state. Where state and federal laws are contrary to each other, the supremacy clause is enforced. The supremacy law dictates that when there is a conflict between state and federal laws, the federal law prevails.\(^\text{15}\) In the case of marijuana, despite state laws allowing for medical and recreational use of marijuana, the federal law under the Controlled Substances Act prohibits marijuana.

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\(^{14}\) Source: Graphic is from the Business Insider website: [http://www.businessinsider.com/arcview-north-america-marijuana-industry-revenue-2016-2017-1](http://www.businessinsider.com/arcview-north-america-marijuana-industry-revenue-2016-2017-1). This site shows current state laws legalizing marijuana for medical or recreational purposes.

\(^{15}\) Source: “Constitution of the United States of America: Analysis and Interpretation” from the website congress.gov. According to Cornell Law, the Supremacy Clause of the United States Constitution (Article VI, Clause 2) establishes that the federal constitution, and federal law generally, take precedence over state laws, and even state constitutions.
As previously stated, the federal government claimed that marijuana is not medicine and in Gonzales v. Raich, and the U.S. Supreme Court ruled that the federal government has the constitutional authority to prohibit marijuana.\textsuperscript{16} Thus, federal prosecutors may prosecute recreational and medical marijuana businesses, even if they reside in a state where marijuana is legal.

Consequently, state marijuana laws, including medicinal and recreational, exist because the federal government does not enforce the federal law. However, the federal government can, at any time, decide to enforce the Controlled Substances Act. While states can object to the enforcement of the Controlled Substances Act, the U.S. Supreme Court ruled on two separate occasions that the federal law does prevail against state laws.

\textbf{IMPACT TO FINANCIAL INSTITUTIONS}

The number of marijuana businesses operating in jurisdictions with legalized marijuana has steadily increased over the past few years.\textsuperscript{17} The North American marijuana market posted $6.7 billion in revenue in 2016, which is a 30 percent increase from 2015. In addition, sales are expected to grow at a compound annual growth rate of 25 percent through 2021, when the North American market is expected to top $20.2 billion.\textsuperscript{18}

Financial institutions face significant risks by participating in the marijuana industry. This includes federal charges since marijuana is prohibited at a federal level as well as enforcement actions for AML violations. Consequently, very few financial institutions provide financial services to marijuana businesses.

\textit{Federal Reaction to the Legalization of Marijuana}

The Cole Memo

In August 2013, the Department of Justice (DOJ) provided guidance to federal prosecutors investigating and prosecuting marijuana-related offenses in light of state marijuana legalization.\textsuperscript{19} This guidance is known as the “Cole Memo” and provided a list of eight enforcement priorities to consider when deciding whether to file criminal charges for conduct related to marijuana. Prosecutors are instructed to consider whether a prosecution is consistent with any of the following priorities:\textsuperscript{20}

\begin{enumerate}
  \item “Preventing the distribution of marijuana to minors
\end{enumerate}

\textsuperscript{16} Source: The Supreme Court of the United States: Case 545 U.S. 1 (2005).
\textsuperscript{17} Marijuana businesses are divided into two categories; direct marijuana businesses and indirect marijuana business. Direct marijuana businesses include growers and dispensaries, and indirect marijuana businesses provide goods or services to direct marijuana businesses.
\textsuperscript{18} Source: Arcview Market Research, a leading publisher of marijuana market research.
\textsuperscript{19} James M. Cole, the Deputy Attorney General, issued guidance regarding marijuana enforcement (“Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement”). This memo is referred to as the “Cole Memo.” The Cole Memo provides guidance to federal prosecutors concerning marijuana enforcement in light of conflicting state laws.
2. Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs and cartels
3. Preventing the diversion of marijuana from states where it is legal under state law in some form to other states
4. Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity
5. Preventing violence and the use of firearms in the cultivation and distribution of marijuana
6. Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use
7. Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands
8. Preventing marijuana possession or use on federal property"

Overall, the Cole Memo states that the DOJ is committed to enforcing the federal law with regards to marijuana. Conversely, the Cole Memo also mentions that states with strong compliance and enforcement programs are less likely to encounter federal prosecution.

**FinCEN and DOJ Guidance**

In February 2014, in response to financial institutions’ unwillingness to provide financial services to marijuana businesses due to the legal implications, FinCEN\(^\text{21}\) and the DOJ\(^\text{22}\) issued separate guidance to financial institutions providing banking services to the marijuana industry.

The FinCEN Guidance states that it “should enhance the availability of financial services for marijuana businesses and the financial transparency of financial institutions providing financial services to those marijuana business” (Financial Crimes Enforcement Network; February 14, 2014; “BSA Expectations Regarding Marijuana-Related Businesses”); yet, the FinCEN Guidance never states that financial institutions that follow the guidelines are exempt from regulatory scrutiny or federal prosecution.

The DOJ Guidance states Congress’ position remains unchanged in that marijuana is a dangerous drug and provides a significant source of revenue for various criminal activity. Nevertheless, the DOJ Guidance recognizes the legalization of marijuana across several states and provides guidance to federal prosecutors to ensure resources are being utilized efficiently and effectively.

**Analysis of the Federal Reaction to Marijuana Laws**

Overall, financial institutions are prohibited from providing financial services to the marijuana industry according to federal law even though the DOJ and FinCEN issued guidance to help alleviate the concerns of financial institutions. The fact remains the same in that financial institutions face the risk of federal prosecution. Whereas the DOJ Guidance and FinCEN Guidance state that financial institutions can provide financial services to the marijuana industry, it is important to note that the guidance is still guidance and guidance is not law. Both the DOJ and FinCEN do not state that financial institutions should not be concerned with the federal prosecution but rather the financial institutions are a lower priority for the

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\(^{21}\) Financial Crimes Enforcement Network; February 14, 2014; “BSA Expectations Regarding Marijuana-Related Businesses”

\(^{22}\) U.S. Department of Justice; February 14, 2014; “Guidance Regarding Marijuana Related Financial Crimes”.
federal government. In addition, the DOJ and FinCEN guidance serves to outline the federal expectation for financial institutions who would like to engage in the marijuana industry.

The main purpose of the FinCEN Guidance is to provide transparency of those financial institutions providing financial services to the marijuana industry through the suspicious activity reporting requirements. Still, with this increase transparency, federal prosecutors and law enforcement are aware of those financial institutions who are actively engaged in the marijuana industry. With increased transparency comes the risk of potential federal prosecution. In addition, the FinCEN Guidance appears to be used as a supplemental resource to the DOJ Guidance in that FinCEN provides guidance on performing due diligence and providing a list of red flags to identify marijuana businesses that appear to violate one of the priorities listed in the Cole Memo.

Furthermore, the DOJ Guidance has a similar limitation in that federal immunity is not stated and even states the following: “This memorandum is not intended, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal. It applies prospectively to the exercise of prosecutorial discretion in future cases and does not provide defendants or subjects of enforcement action with a basis for reconsideration of any pending civil action or criminal prosecution” (U.S. Department of Justice, “Guidance Regarding Marijuana Related Financial Crimes,” February 14, 2014.).

Finally, since marijuana is illegal under federal law, the BSA would still require a financial institution to file a SAR with FinCEN each time the financial institution processes a transaction related to a customer that is engaged in a marijuana business. This aspect is clearly outlined in the FinCEN Guidance where FinCEN outlines the requirements for limited” SAR filings, “priority” SAR filings, and “termination” SAR filings.

The existence of the DOJ Guidance and the FinCEN Guidance demonstrates that the federal government is working toward a solution for the industry. Wording within the FinCEN Guidance specifically states that “financial institutions can provide services to marijuana-related businesses consistent with their BSA obligations” and also point out that having this clarity “should enhance the availability of financial services for, and the financial transparency of, marijuana-related businesses” (Financial Crimes Enforcement Network, “BSA Expectations Regarding Marijuana-Related Businesses,” February 14, 2014.).

**Suspicious Activity Reporting Requirements**

According to the FinCEN Guidance, financial institutions remain obligated to file a SAR if there is a transaction involving marijuana because such transactions remain illegal under federal law. The FinCEN Guidance provides a modified SAR reporting system that allows financial institutions to file a “limited” SAR for marijuana businesses that do not implicate any of the Cole Memo priorities, and a “priority” SAR for a customer’s marijuana business that implicates one of the Cole Memo priorities or violates state law.

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23 “Marijuana Limited” SAR Filings - A financial institution providing financial services to a marijuana-related business that it reasonably believes, based on its customer due diligence, does not implicate one of the Cole Memo priorities or violate state law should file a “Marijuana Limited” SAR. Source: Financial Crimes Enforcement Network. February 14, 2014. “BSA Expectations Regarding Marijuana-Related Businesses”

24 “Marijuana Priority” SAR Filings - A financial institution filing a SAR on a marijuana-related business that it reasonably believes, based on its customer due diligence, implicates one of the Cole Memo priorities or violates state law should file a “Marijuana Priority” SAR. The content of this SAR should include comprehensive detail in
Financial institutions are instructed to file a “termination” SAR if a financial institution deems it necessary to terminate a relationship with a marijuana business in order to maintain an effective AML compliance program.

**Impact of FinCEN Guidance**

Overall, SARs related to marijuana represent an emerging trend according to FinCEN. According to a speech by FinCEN Director Jennifer Shasky Calvery on August 12, 2014, just over 1,000 marijuana-related SARs had been received by FinCEN between February 2014 and August 2014. A financial institution filing a SAR on a marijuana-related business that it reasonably believes, based on its customer due diligence, implicates one of the eight priorities or violates state law should file a SAR with the phrase “Marijuana Priority” in the narrative. As of August 2014, FinCEN has received 123 SARs indicating “Marijuana Priority.” Lastly, if a financial institution deems it necessary to terminate a relationship with a marijuana business in order to maintain an effective AML program, it should file a SAR and note in the narrative the basis for the termination, using the term “Marijuana Termination” in the narrative. Just over 475 SARs filed as of August 2014 reflect “Marijuana Termination.”

Based on the SAR data presented by former FinCEN Director Jennifer Shasky Calvery, the FinCEN Guidance issued in February 2014 is having the intended effect because financial institutions are filing SARs thereby increasing the transparency of funds from marijuana businesses to law enforcement.

**Risk to Financial Institutions**

Financial institutions engaged in the marijuana industry may face federal criminal charges regardless of state law. Financial institutions who wish to provide financial services to marijuana businesses are faced with implementing controls to mitigate the risk of providing financial services that are illegal under federal law. In addition, financial institutions must continue to be compliant with the BSA of 1970.

In addition to prosecution for money laundering or abetting a criminal enterprise, financial institutions are worried about the reputational risk of banking marijuana businesses—they do not want media coverage, fear pushback from customers, and are worried they could even potentially be held liable if something went wrong with a marijuana-business client. Intensifying those concerns is the fact that the FinCEN Guidance requires financial institutions to file SARs for every marijuana-related account. For financial institutions, filing SARs on those customers and continuing to provide financial services to those in accordance with existing regulations and guidance. Source: Financial Crimes Enforcement Network. February 14, 2014. “BSA Expectations Regarding Marijuana-Related Businesses”

25 “Marijuana Termination” SAR Filings - If a financial institution deems it necessary to terminate a relationship with a marijuana-related business in order to maintain an effective anti-money laundering compliance program, it should file a SAR and note in the narrative the basis for the termination. Financial institutions should use the term “Marijuana Termination” in the narrative section. Source: Financial Crimes Enforcement Network. February 14, 2014. “BSA Expectations Regarding Marijuana-Related Businesses”

26 Source: FinCEN “SAR Stats: Technical Bulletin” in October 2015. The term “Emerging” indicates: 1) An activity that was not trending the year previous; and 2) An activity that was referenced with more frequency than other activities mentioned within the same category.


customers might draw unwanted attention and scrutiny from bank examiners. This is because the financial institutions have repeatedly filed SARs on customers who may be engaged in illegal activity according to federal law. These reputational and regulatory risks compound their fears.

Regulatory Uncertainty

Since the BSA requires financial institutions to report suspicious activity and the FinCEN Guidance outlines the types of SARs required based on the transaction types for marijuana businesses, financial institutions are exposed to the risk of being viewed as facilitating money laundering. The reason being that marijuana is prohibited at the federal level, and therefore, financial institutions may face potential fines.

As FinCEN is responsible for enforcing the AML regulations, if financial institutions abide by the DOJ Guidance and FinCEN Guidance, this may reduce the risk of potential fines for AML violations. However, FinCEN can also impose fines if the financial institutions are not fully align to DOJ Guidance and FinCEN Guidance.

While federal prosecutors view the marijuana industry with less concern, the banking regulators can still enforce the federal law. Specifically, the three primary banking regulators (Federal Reserve Banks, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency) still have a duty to determine if financial institutions are complying with federal law and can impose various corrective actions like civil money penalties, cease and desist orders, and fines.

For example, in November 2015 the Fourth Corner Credit Union applied to the Federal Reserve Bank of Kansas City, which is the regional bank for the board of governors of the Federal Reserve System, for a master account. The account allows banks to transact business. The application was rejected by the Federal Reserve, and a Colorado judge dismissed a lawsuit seeking federal approval. Overall, U.S. District Judge R. Brooke Jackson said that the reason the application was rejected was because marijuana is illegal under federal law.

Customer Monitoring and SAR Reporting

Financial institutions considering providing financial services to marijuana business will have to assess the appropriate initial and ongoing due diligence required that meets the expectations of the DOJ Guidance and FinCEN Guidance. To accomplish this, financial institutions will have to identify the potential risk factors present in the marijuana industry and the appropriate means to address those risk factors.

In addition, financial institutions will have an increase in SAR filings to ensure compliance with the FinCEN Guidance, which will require at least a “Marijuana Limited” SAR filing for each transaction. In addition,

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29 FinCEN, a bureau of the U.S. Treasury, is the delegated administrator of the BSA. FinCEN relies on the federal banking agencies to examine banks within their respective jurisdictions for compliance with the BSA. Source: https://www.fincen.gov/
30 According to the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual, the federal banking agencies are responsible for the oversight of the various banking entities operating in the United States, including regulating, and supervising banks. The federal banking agencies may use their authority to enforce compliance with appropriate banking rules and regulations, including compliance with the BSA.
31 Source: The Denver Post “Judge tosses Denver marijuana credit union’s suit for federal approval”. This article provides an example of the regulatory risks financial institutions are exposed to when accessing the FRB services.
once financial institutions file their first Limited or Priority SAR, they must continue filing every 90 days. For example, in Colorado, the number of retail and medical marijuana businesses at year-end in 2015 was 2,597. A financial institution would have to file a SAR every 90 days for each business or 2,597 SARs quarterly. This increase in volume would require additional resources to ensure SARs are filed in accordance with regulatory requirements as well as the FinCEN Guidance.

**Cash-Intensive Industry**

Financial institutions considering providing financial services to marijuana business will have to conduct transactions that are mostly cash-based, which is a red flag noted in the FinCEN Guidance. The main risk of a cash-intensive industry is the origin of the funds may be unknown. In addition, the amount of funds will vary since the marijuana industry is still growing. This will result in financial institutions continually reassessing the anticipated cash flows for transaction monitoring purposes.

The Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual states that “some businesses and entities may be misused by money launderers to legitimize their illicit proceeds. For example, a criminal may own a cash-intensive business...and use it to launder currency from illicit criminal activities. The business’ currency deposits with its bank do not, on the surface, appear unusual because the business is legitimately a cash-generating entity. However, the volume of currency in a [business] used to launder money is most likely be higher in comparison with similar [businesses] in the area. The nature of cash-intensive businesses and the difficulty in identifying unusual activity may cause these businesses to be considered higher risk” (FFIEC BSA/AML Examination Manual: Cash-Intensive Businesses — Overview).

**Red Flags Associated withMarijuana Businesses**

As previously discussed, there are three types of SAR designations: “limited,” “priority,” and “termination.” These designations are to be noted in the SAR narrative and impact the type of content that should be in the narrative. Determining the type of SAR to file will depend on the red flags identified by the financial institution.

While red flags tend to be similar for high-risk industries such as money services business, trade finance, and real estate, financial institutions providing services to marijuana business should evaluate their existing red flags to determine if the red flags address activities associated with marijuana businesses. In

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32 According to the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual, one purpose of filing SARs is to identify violations or potential violations of law to the appropriate law enforcement authorities for criminal investigation. This objective is accomplished by the filing of a SAR that identifies the activity of concern. If this activity continues over a period of time, such information should be made known to law enforcement and the federal banking agencies. FinCEN’s guidelines have suggested that banks should report continuing suspicious activity by filing a report at least every 90 calendar days. Subsequent guidance permits banks with SAR requirements to file SARs for continuing activity after a 90 day review with the filing deadline being 120 calendar days after the date of the previously related SAR filing.

33 Source: Colorado Department of Revenue: Marijuana Enforcement Division. 2015 Annual Report. To illustrate the growth of marijuana business in Colorado, the number of marijuana businesses in 2014 was 2,249. The number of marijuana in 2015 represents a 15 percent increase.
addition, financial institutions should map the existing red flags to the red flags noted in the FinCEN Guidance.

The following FinCEN red flags indicate that a marijuana business may be engaged in activity that implicates one of the Cole Memo priorities or violates state law.34

1. “A marijuana business appears to be using a state-licensed marijuana business as a pretext to launder money related to other criminal activity
2. A marijuana business cannot produce sufficient documentation and other evidence to demonstrate that it is duly licensed and operating in a manner consistent with state law
3. A marijuana business cannot demonstrate the legitimate source of significant outside investors
4. A marijuana business appears to be disguising its involvement in the marijuana industry
5. A review of publicly available information about a marijuana business and related parties reveals negative information
6. A marijuana business or related parties have been subject to state or local enforcement actions.
7. A marijuana business engages in international or interstate activity
8. The owners or related parties of a marijuana business reside outside of the state in which the marijuana business is located
9. A marijuana business is located on federal property or marijuana that is sold by the business is grown on federal property
10. A marijuana business’ proximity to a school is not in compliance with state law
11. A marijuana business purporting to be a “nonprofit” is engaged in commercial activity inconsistent with its designation as a nonprofit”

RECOMMENDATIONS

For financial institutions, the question of whether to serve marijuana businesses is if the benefit exceed the risk. For large institutions with more sophisticated AML operations, the risk of serving the marijuana industry has been too high and the potential rewards too low. However, recently, the marijuana industry’s growing size has increased the profit potential.35 There are many tools that financial institutions can leverage to reduce the risk that marijuana businesses are violating state laws or federal enforcement priorities, as well as identify a legitimate business used as a front for marijuana for those financial institutions who do not want to serve the marijuana industry. First, financial institutions should perform a risk assessment and determine if the residual risk is aligned with the risk appetite. Secondly, based on the results of the first exercise, financial institutions should implement appropriate due diligence and transaction monitoring rules. The following sections provide further details on addressing these actions.

AML Risk Assessment

The key purpose of a money laundering risk assessment is to drive improvements in financial crime risk management through identifying the general and specific money laundering risks a financial institution is

34 Source: Financial Crimes Enforcement Network; February 14, 2014; “BSA Expectations Regarding Marijuana-Related Businesses”.
35 As previously stated, the North American marijuana market posted $6.7 billion in revenue in 2016, up 30% from the year before. Additionally, sales are expected to grow at a compound annual growth rate of 25% through 2021, when the North American market is expected to top $20.2 billion. Source: Arcview Market Research, a leading publisher of marijuana market research.
facing, determining how these risks are mitigated by a financial institution’s AML Program controls, and establishing the residual risk that remains for the financial institution.36

If a financial institution has a thorough understanding of the marijuana laws governing its state, has addressed the profitability of banking marijuana business with the financial and reputational risk, and is going to proceed with offering financial services, the financial institution should consider the following factors when updating its AML Risk Assessment:

1. Address the legal, reputational, and compliance risk associated with serving marijuana businesses
2. Incorporate and assess the changes in state and federal marijuana laws

If a financial institution does not want to service marijuana business, it must ensure that their AML programs are adequately designed to mitigate against indirect risk exposures to that particular industry. Questions that should be incorporated into the AML Risk Assessment include:

1. Does the financial institution operate in a state where marijuana is legal or pending legislation?
2. Does the financial institution maintain customer relationships with:
   a. Real estate leasing companies whose tenants may include marijuana businesses?
   b. Companies that sell or lease equipment that may be used in the production or sale of marijuana?

Overall, risk assessments should be reviewed on an ongoing basis, by comparing the assessment with the financial institution’s current products, service offerings and customer mix to ensure that the risk assessment is comprehensive and to identify areas that currently pose risks to the financial institution.

Assess Risk Appetite

According to the Wolfsberg Group, the result of the AML Risk Assessment will explain the current residual AML risk being assumed by the financial institution.37 A financial institution should determine if the residual risk is aligned to the financial institution’s risk appetite.38 If the residual risk exceeds the risk appetite, then measures will have to be implemented to reduce the residual risk to an acceptable level. This can be accomplished through either reducing the inherent risk or strengthening the control environment. If the residual risk exceeds the risk appetite, financial institutions can reassess its risk appetite to better align the risk appetite to the residual risk. When assessing risk appetite, management should consider the reputation risk and the regulatory risk.

36 Source: The Wolfsberg Group. “The Wolfsberg Frequently Asked Questions on Risk Assessments for Money Laundering, Sanctions and Bribery & Corruption”. A risk assessment is an exercise used to identify key risks faced by the firm and to test the controls that a firm has in place to mitigate these risks. Risks can be both external and internal to the firm. The risk assessment measures the inherent risks a firm has actions to reduce these risks to arrive at the residual risk.
38 Source: The Wolfsberg Group. “The Wolfsberg Frequently Asked Questions on Risk Assessments for Money Laundering, Sanctions and Bribery & Corruption”. A risk appetite statement is the amount and type of risk that a financial institution is willing to take in order to meet its strategic objectives – this includes reference to both the financial institution’s risk appetite as well as its risk tolerance.
Reputation Risk

Reputational damage can arise in numerous ways which affects the good reputation of a financial institution. A financial institution’s reputation in this area is usually negatively affected by the announcement of a serious investigation into money laundering. This is usually in connection with client accounts and/or transactions, which may have a financial impact through regulatory, civil or criminal monetary fines and penalties.

In addition, businesses that transact primarily in cash can be a red flag and may draw attention from regulators. Therefore, most financial institutions will stay focused on providing services to business that have made them successful in the past and which do not introduce reputational risk issues.

Regulatory Risk

While AML regulations have remained constant over the past several years, regulatory expectations continue to evolve, and expectations continue to increase as to how a financial institution should execute their AML program. Consequently, regulatory fines and penalties against financial institutions also continues to increase. In addition, financial institutions are experiencing more frequent examinations of their AML program as well as in-depth reviews of certain aspects of their AML program. Even if financial institutions do not receive fines or penalties, regulators can still require corrective actions that can be costly to remediate.

Overall, no matter how the results of an AML Risk Assessment are compared against a financial institution’s risk appetite, resulting actions should be made clear. Therefore, it is a critical part of the process that roles and responsibilities are clearly defined to ensure that if risks taken are beyond both the risk appetite and the control framework, then a consequence management/procedure is in place.

Initial and Periodic Due Diligence

Customer due diligence is a critical part of any AML program because it determines if the financial institution should enter into a relationship with an individual or entity. Pursuant to the FinCEN Guidance, before deciding whether to open, close, or refuse any particular account or customer relationship, the financial institution should conduct a thorough risk-based due diligence that includes a variety of tasks:

1. “Verifying with state authorities whether the marijuana business is licensed and registered.
2. Reviewing the state application and supporting documentation submitted by the marijuana business to state authorities in support of its marijuana application.

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39 Types of corrective action are the same across the three primary regulators (Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency): Matters Requiring Board Attention, Matters Requiring Immediate Attention, and Matters Requiring Attention.

40 Source: Financial Crimes Enforcement Network; February 14, 2014; “BSA Expectations Regarding Marijuana-Related Businesses”.
3. Requesting from state authorities information related to the marijuana business and individuals involved with it. A critical component is identifying the beneficial owners\textsuperscript{41} and performing due diligence on those individuals.

4. Developing an understanding of the marijuana business’ normal and expected activity, including the products it sells and types of customers it serves.\textsuperscript{42} For example, obtain the sources of product, such marijuana grown in-house or purchased from a dispensary. If the product is grown in-house, obtain the history of providing to other marijuana dispensaries, including the names and the amount of marijuana provided. Additionally, obtain information on the number and demographic of medical patients. Furthermore, understand business capital source and cash activity volumes and review related business interests. Finally, perform on-site visits of the marijuana business to understand the potential output and growth and to verify the legitimacy of the business.

5. Ongoing monitoring of adverse public information concerning the marijuana business. This can include any pending lawsuits initiated by the business or pending lawsuits against the business. Information that should be obtained include potential outcomes of the lawsuits, individuals involved and the histories of the lawsuits.

6. Ongoing monitoring for any suspicious activity. This includes any automated transaction monitoring that is tailored to the marijuana industry as well as suspicious activity identified by employees.

7. Updating the due diligence information on a periodic basis.”

Considering initial customer due diligence is defined by the FinCEN Guidance, ongoing due diligence should be performed to ensure the marijuana business information is current and to identify any potential red flags. The frequency of the ongoing due diligence should be based on the risk of the business. Since the marijuana industry is relatively new, ascertaining the risk may prove challenging. Therefore, the risk assessment should be conservative until the financial institution has sufficient information to better assess the risk.

Even though the FinCEN Guidance also provides a non-exhaustive list of red flags that may indicate a marijuana business is engaged in activity that implicates one of the Cole Memo priorities or violates state law, robust customer due diligence and continual monitoring are essential before a financial institution can safely conclude that it can reliably provide financial services to the business.

\textit{Transaction Monitoring Rules}

While most financial institutions have automated transaction monitoring rules, those rules will need to be reevaluated to ensure they capture the activities associated with marijuana businesses. This should be performed regardless if the financial institutions provide financial services to the marijuana industry. For example, common transaction monitoring rules that detect out of pattern activity or cash transaction will need to be adjusted for activity associated with marijuana businesses. This includes adjusting transactional thresholds and accounting for the fact that the marijuana industry is predominantly cash-based. Therefore, financial institutions should anticipate frequent cash deposits from marijuana

\textsuperscript{41} Financial institutions will have to identify and perform due diligence on beneficial owners as required by the FinCEN “Customer Due Diligence Requirements for Financial Institutions” rule, which becomes effective May 2018.

\textsuperscript{42} Financial institutions who do not want provide financial services to marijuana business should also determine if they would like to serve businesses that are auxiliary to the marijuana business.
businesses. In addition, financial institutions should monitor activity of a marijuana business that conducts transactions in states where marijuana is illegal. Examples of transaction monitoring rules include the following:

1. A business uses the financial institution’s account to move funds from one state where marijuana is legal to another state where marijuana is illegal. The movement of funds can be Automated Clearing House (ACH) transfers, wire transfers, or Automated Teller Machine (ATM) withdrawals. For example, a business conducts transactions above a certain threshold in a state other than that in which the business is located in.

2. A business uses the financial institution’s account to move funds in amounts that are unsupported by the business’ income. The movement of funds can be ACH transfers, wire transfers, or ATM withdrawals.

3. A business uses the financial institution’s account to convert cash into goods or services, in a manner that differs from the previous account activity patterns. Similarly, a business uses the financial institution’s account to move funds in a manner that differs from previous account activity patterns or make purchases in a manner inconsistent with their history. For example, a business that makes multiple ATM transactions at night, such as five or more successful ATM transactions between the hours of midnight and 5 am.

4. A business makes high-value charges in a manner inconsistent with its history in an attempt to either transfer value or layer the proceeds of criminal activity. For example, an account is used to conduct a transaction where the value of the transaction represents a specific percentage increase over the account’s previous highest-value transaction.

5. A business breaks up a single, large cash deposits into multiple and smaller cash payments, at or just below the cash transaction reporting (CTR) threshold.43

Regardless if the financial institution actively engages with marijuana businesses, transaction monitoring rules should be calibrated to identify potential suspicious activity related to marijuana business activities. This enables financial institutions to file SARs in accordance with the FinCEN Guidance. In addition, this enables financial institutions to terminate the account relationship via a “Marijuana Termination” SAR if the financial institution does not want to provide financial services to marijuana businesses.

**CONCLUSION**

The marijuana industry appeals to financial institutions since marijuana businesses are expected to grow at a compound annual growth rate of 25 percent through 2021, when the North American market is

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43 According to the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual, a bank must electronically file a Currency Transaction Report (CTR) for each transaction in currency (deposit, withdrawal, exchange, or other payment or transfer) of more than $10,000. Multiple currency transactions totaling more than $10,000 during any one business day are treated as a single transaction if the bank has knowledge that they are by or on behalf of the same person. While financial institutions will have increase suspicious activity reporting (SAR), they will also face increase CTR filings. The purpose of the transaction monitoring rule is for financial institutions to better identify CTR filings, which may be indicative of suspicious activity.
expected to top $20.2 billion. By providing financial services to marijuana businesses, financial institutions can capture some of the industry’s rapid financial growth.

However, financial institutions that provide financial services to marijuana businesses should treat marijuana business like other high-risk industries. First, they must assess the risk of engaging in the industry, determine if the risk aligns with the risk appetite, and proceed accordingly by adjusting the AML program to comply with both the state and federal laws. If the risk assessed exceeds the risk appetite, the financial institutions must adjust the AML program to detect activity associated with the marijuana industry.

In addition, since marijuana is prohibited by federal law, financial institutions that wish to participate in the marijuana industry will need to accept the risk associated with this industry, including the potential enforcement of AML regulations against the financial institutions. The level of risk faced by the financial institutions can be reduced by enhancing the AML program to account for the nuances posed by the marijuana industry and aligned the AML program to the DOJ Guidance and the FinCEN Guidance. However, financial institutions must still be cognizant that the federal government still can enforce the federal laws regardless of the state laws and regardless of if the financial institution is complying with the DOJ Guidance and FinCEN Guidance.

As the number of states legalize marijuana for medical or recreational use, the demand for financial services will increase. Guidance from the DOJ and FinCEN will have to evolve to account for growth of the marijuana industry and the challenges posed by the federal laws to help guide financial institutions wishing to enter this industry but at the same time provide guidance to those financial industries that would like to be precluded from the industry.

Overall, the AML requirements remain unchanged. Financial institutions must have an AML program in place to reasonably identify and report suspicious behavior. Since the marijuana industry is relatively new, financial institutions should proceed with caution to ensure its AML program meets the regulatory requirements.

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44 Source: Arcview Market Research, a leading publisher of marijuana market research.
**WORKS CITED**


