

Even legal marijuana businesses pose serious money laundering risks for banks and investors

Marijuana might be legal in some places, but as IRS audits increasingly show, just doing business with the legal marijuana industry brings significant compliance challenges, especially for the financial services world.

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Although investment in the state-legal marijuana industry has been growing at rapid pace, the IRS' recent audits of over thirty marijuana businesses in Colorado should concern everyone connected to the marijuana industry, including banks that serve the industry and investors. The industry-wide investigation, perhaps prompted by frequent reports of multi-billion dollar revenues in legalized marijuana, demonstrates that, despite popular support for legalization, there remains a significant risk of federal enforcement actions under anti-money laundering ("AML") laws. Indeed, the number of businesses subjected to audits, and those audits' detailed focus on marijuana-related activities suggest a specific law enforcement interest in the industry. Accordingly, marijuana businesses, and their investors and banks, should seize this opportunity to assess and mitigate their risks under AML laws.

Participants in the marijuana industry have always been cognizant of the obvious risk of federal law enforcement action for violations of the Controlled Substances Act, which prohibits the manufacture and distribution of marijuana regardless of state laws. However, more sophisticated industry participants and their advisors know that the greater risk comes from the enforcement of AML laws against marijuana

businesses, ancillary businesses, and financial institutions is arguably a greater risk.

The risk arises from a simple reality: currently, every business in the industry, including every bank and investor, is violating AML laws. Generally speaking, AML laws prevent people and businesses from knowingly receiving or participating in transactions with money that is known to be derived from certain federally illegal activities, such as the sale of marijuana. So every time a business that sells marijuana pays another party or deposits funds in a bank, the recipient of funds has knowingly engaged in a financial transaction with the proceeds of illegal activity. Knowingly transacting business with the proceeds of marijuana manufacture or distribution can result in a fine of \$250,000 or twice the value of the transaction, as well as a prison sentence of up to ten years.

Beyond the risk of engaging in money laundering, marijuana businesses, investors, and banks also may be subject to enforcement actions under AML laws for deficiencies in their compliance programs. For example, all businesses must report the receipt of cash payments greater than \$10,000 on a Form 8300 and any interests in foreign accounts with a value over \$10,000. And under the Bank Secrecy Act ("BSA"), fi-

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financial institutions, such as banks and money transmitters, are required to have systems and controls to prevent money laundering, including monitoring their clients' activity for potential money laundering.

Even though knowingly transacting with funds derived from the sale of marijuana is illegal, many banks serve the industry, and high-profile investors continue to fund various marijuana businesses. These banks' and investors' participation has been facilitated by the U.S. Department of Justice's ("DOJ") policies concerning state-legal marijuana businesses. On August 29, 2013, the DOJ issued the Cole Memorandum, which provided that the DOJ would refrain from using its resources to prosecute state-legal marijuana businesses if those businesses did not violate eight stated enforcement priorities, such as preventing the distribution of marijuana to minors and preventing the diversion of marijuana to states where it is not legal. The following year, DOJ's Guidance Regarding Marijuana Related Financial Crimes (the "DOJ Guidance") laid out a policy that prosecutors should not use their resources to bring money laundering charges against state-law compliant businesses that do not violate DOJ's enforcement priorities. Simultaneously, the Treasury Department's Financial Crimes Enforcement Network's ("FinCEN") issued guidance entitled "BSA Expectations Regarding Marijuana-Related Businesses" (the "FinCEN Guidance"). The FinCEN Guidance described FinCEN's and expectations for financial institutions that transact with marijuana businesses, including obligations related to suspicious activity monitoring and reporting.

IRS audits highlight enforcement risks

Media reports indicate that the IRS' audits of marijuana business are related to those businesses' Form 8300 filings (or their failure to make such filings). However, a closer look at the audit forms reveals a more comprehensive and substantive IRS inquiry. The IRS is asking direct questions about marijuana businesses' compliance with state marijuana laws, including questions about inventory tracking, growing methods, and customers. While it is impossible to say for certain why the IRS is asking questions related to compliance with state law, one frightening prospect is that the government is trying to identify businesses who may not be fully compliant with state laws and federal enforcement priorities.

Moreover, the IRS is asking questions related to the training of employees and businesses' systems and controls related to AML laws. For example, the IRS is asking about records generated by businesses' point-of-sale systems, businesses' bank accounts, and how employees are trained with respect to AML laws. These questions can reveal whether and how

businesses may have violated AML laws, and are the types of questions that are often at the heart of money laundering cases (not just ones against marijuana businesses).

To date, marijuana businesses, banks, and investors have benefitted from the hands-off policy articulated in the DOJ Guidance and Cole Memorandum. But if the IRS audits expose that certain businesses are not compliant with state law or the DOJ's enforcement priorities, then those businesses—and their banks and investors—may find themselves subject to prosecution because they are outside of the policy set forth in the Guidance. Specifically, if an IRS audit determines that a marijuana business' compliance is not sufficient to follow within the policies articulated in DOJ's Guidance and Cole Memorandum, the government will question whether a bank serving that business also should have known of that businesses' non-compliance. The government's scrutiny could then turn to a bank's AML compliance program, opening up the bank to potential enforcement actions under the BSA, like the one taken against Millennium Bank in Illinois.

Banks and investors can take steps to mitigate their AML risks now, before marijuana businesses they work with are audited. Banks should focus on their diligence of MRB customers, ensuring it meets or exceeds the expectations set forth in FinCEN's guidance. Specifically, banks must be able to ensure their clients' marijuana sales are legal under state law, that clients' revenues are in line with expectations, that there are no suspicious movements of client funds, and that the client's beneficial ownership is understood. Banks should also look at marijuana businesses' policies and procedures for state-law compliance to see if they are sufficiently robust. Further, banks should have in place procedures for when and how they will file each of the marijuana-related suspicious activity reports described in the FinCEN Guidance. Lastly, if banks find that their MRB clients are non-compliant, they must either come up with a plan to quickly bring that client into compliance with state law and federal guidance, or they must terminate that relationship.

Many investors are not required to have AML compliance programs under the BSA, and therefore also are not the intended targets of the FinCEN Guidance. Nonetheless, investors would be wise to incorporate aspects of the FinCEN Guidance into their due diligence on investments in marijuana businesses. Doing so will ensure investors can detect non-compliance by marijuana businesses in which they have invested. Additionally, investors can negotiate investment terms that mitigate risk. For example, investors can negotiate audit rights sufficient to determine a marijuana business' compliance with state law. They can also reach deal terms that allow rescission of an investment if the marijuana

business is in material non-compliance with state law or federal enforcement priorities.

While compliance measures must reflect the unique nature of the marijuana industry, AML enforcement actions against banks and investors involved in the marijuana will, in some respects, look similar to AML enforcement actions in other contexts. Therefore, banks and investors should also seek advice from professionals who are experienced not just with the marijuana industry, but also with AML laws and government enforcement.

While the full import of the IRS' audits of marijuana businesses remains uncertain, it is indisputable that banks and investors who participate in the marijuana industry face serious risks under AML laws. As long as marijuana remains federally illegal, banks and investors that wish to participate in the industry will need to tolerate a certain degree of risk. However, the magnitude of that risk can be significantly reduced through smart compliance programs that account for the nature of the marijuana industry, as well as continually evolving federal policies. ■