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The Latest in Cannabis Finance



BNY MELLON

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The Latest in Cannabis Finance



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The Latest in Cannabis Finance



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Cannabis Banking 101

Financing a cannabusiness in the United States is very difficult because of cannabis banking challenges:

- Cannabis is illegal under federal law.
 - Schedule I controlled substance under the Controlled Substance Act (CSA), Sections 812 and 828(a).
 - Drug paraphernalia is also illegal under the CSA, Section 863.
 - Leasing, renting, using or maintaining drug-involved premises is also illegal under the CSA, Section 856.

Cannabis Banking 101

Banking cannabis is also illegal under federal law.

- 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. 18 U.S.C. § 1956(a).
 - Includes sale of cannabis in violation of the CSA.

Cannabis Banking 101

- “Financial institutions” are required to report suspicious transactions relevant to possible violations of the law. 31 U.S.C. § 5318(g).
 - Includes transactions involving sale of cannabis in violation of the CSA.
 - Failure to report suspicious transactions could result in criminal liability for financial institutions and their directors, officers, employees and agents, under the Bank Secrecy Act (BSA).
 - “Financial institution” includes banks, bankers, broker / dealer firms, investment banks, currency exchanges, real estate closing companies, insurance companies, etc.

Cannabis Banking 101

Cole Memorandum (August 2013)

- Issued by U.S. Deputy Attorney General James M. Cole, as guidance to U.S. Attorneys on investigating and prosecuting CSA violation in states that have legalized marijuana.
- Preceded by Ogden Memo (October 2019).
 - First guidance memorandum.
 - Issued by U.S. Deputy Attorney David W. Ogden to U.S. Attorneys related to the CSA and medical marijuana.
 - DOJ is committed to enforcement of CSA.
 - DOJ is also committed to making “efficient and rational use” of its limited resources.
 - DOJ priority in prosecuting CSA violations should not focus federal resources in states that have legalized marijuana, when the individuals and companies are in clear and unambiguous compliance with existing state laws.

Cannabis Banking 101

Cole Memorandum (continued)

- DOJ enforcement of CSA violations should focus on enforcing 8 priorities:
 - Distribution of cannabis to minors.
 - Revenue from sale of cannabis going to criminal enterprises, gangs and cartels.
 - Diversion of cannabis to states where it is not yet legal.
 - Cannabis activity being used as cover or pretext for trafficking other illegal drugs or other illegal activity.
 - Violence and use of firearms in sale of cannabis.
 - Drugged driving and exacerbation of other adverse public health consequences.
 - Growing cannabis on public lands.
 - Possession of cannabis on federal property.

Cannabis Banking 101

FinCEN Guidance (February 2014)

- Financial Crimes Enforcement Network (“FinCEN”) issued a memorandum providing guidance to clarify BSA expectations for financial institutions providing services to cannabis-related businesses.
 - Not just plant touching, but also ancillary product and service providers.
- Clarifies how financial institutions can provide services to cannabis-related-businesses consistent with their BSA obligations.
- FinCEN’s hope that the guidance would enhance the availability of financial services and financial transparency for cannabis-related businesses.

Cannabis Banking 101

FinCEN Guidance (continued)

- “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.”
- Factors should include:
 - Business objectives of the financial institution.
 - Evaluation of the risks associated with offering a particular product or service.
 - Financial institution’s capacity to manage the risks effectively.

Cannabis Banking 101

FinCEN Guidance (continued)

- When evaluating factors in FinCEN Guidance, thorough customer due diligence is a critical aspect of making this assessment.
- At a minimum, due diligence procedures should include:
 - Verifying with appropriate state authorities whether the business is duly licensed and registered.
 - Reviewing the business' license application and related documents.
 - Requesting available information about the business and related parties.
 - Developing an understanding of the normal and expected business activities.
 - Ongoing monitoring of publicly available information.
 - Ongoing monitoring for suspicious activity including FinCEN Guidance red flags.
 - Refreshing information obtained through due diligence, on a period basis.

Cannabis Banking 101

FinCEN Guidance (continued)

- FinCEN Guidance identifies red flags that cannabis business may be engaged in activity that violates state law or Cole Memorandum priorities:
 - Business receives more revenue than expected or compared to competitors.
 - Business deposits more cash than reported on taxes.
 - Rapid movement of funds in and out of accounts.
 - Deposits by third-parties with no connection to account holder.
 - Comingling of funds between business and owner accounts.
 - Financial statements inconsistent with account activity.
 - Unable to demonstrate legitimate source of outside investments.
 - Use of non-descript names such as “consulting,” “holding” or “management.”
 - Owners’ residence and location of business are in different states.
 - Business claims to be non-profit while engaged in commercial activity.

Cannabis Banking 101

FinCEN Guidance (continued)

- Financial institutions are required to file suspicious activity reports (SARs) with FinCEN if it knows, suspects or has reason to suspect transaction conducted through the financial institution involves funds derived from illegal activity.
- 3 types of SARs, depending on outcome of due diligence:
 - Cannabis Limited – no Cole Memorandum priorities implicated.
 - Cannabis Priority – at least one (1) Cole Memorandum priority implicated.
 - Cannabis Termination – relationship with account holder being terminated for anti-money laundering or BSA violations.

Cannabis Banking 101

Second Cole Memorandum (February 2014)

- Issued the same day as FinCEN Guidance.
- Investigations and prosecutions of violations of BSA for cannabis businesses should be subject to same consideration as CSA violations under Ogden Memorandum and Cole Memorandum.
- All federal guidance memorandums make clear that they are just guidance for the exercise of investitive and prosecutorial discretion by the DOJ.
 - Make clear that nothing in the guidance memorandums provides a legal defense or restricts the DOJ's discretionary authority to enforce federal law.

Cannabis Banking 101

Sessions Memorandum (January 2018)

- Attorney General Jeffrey Sessions rescinded all prior cannabis-related guidance memorandums including Ogden Memorandum, Cole Memorandums and FinCEN Guidance.

Rohrabacher – Farr Amendment

- Part of appropriations bill every year since 2001.
- Prohibits DOJ from using federal funding to prosecute CSA violations against medical cannabis operators in strict compliance with state laws.

Cannabis Banking 101

What does the future hold?

- SAFER Banking Act
 - Cleared Senate Committee on Banking, Housing and Urban Affairs at end of September 2023.
 - Prior versions (SAFE Banking Act) passed House votes several times, but SAFER Act is first time Senate members have voted in favor of the measure.
 - Sent to House and Senate floors for debate, amendment and votes.
 - Would prevent federal banking regulators from taking adverse actions against institutions servicing state-sanctioned cannabis businesses.
- Federal legalization?

Cannabusiness Financing

Traditional financing options are very limited due to federal illegality of cannabis.

- Most financial institutions do not provide services to cannabis businesses out of fear of BSA prosecution.
 - Too risky.
 - Too expensive to comply with FinCEN Guidance.
 - Lack of familiarity with the cannabis industry.
 - Lack of access to errors and omissions insurance.
 - Reputational risk.
 - Cannabis industry is in under careful watch by regulators.

Hemp in the United States

Hemp is legal under federal law

- 2018 Farm Bill
 - Definition of hemp and amended definition of marijuana under CSA
 - Created state and federal regulatory requirements under USDA oversight
 - Key elements of legalization of hemp:
 - Must be legal hemp (plant or infused-products cannot exceed 0.3% THC) DELTA-9 THC
 - Testing requirements
 - Reporting requirements
 - Non-compliant plant and product handling requirements
 - Corrective action plan requirements
 - Negligent vs. Intentional Violations
 - Hemp cultivation may be legal under USDA-approved state plan or federal plan (for operators in states without a USDA-approved state plan)

Hemp in the United States

Hemp is legal under federal law . . . sort of!!!

- CBD
 - Food and Drug Administration says CBD is a “drug” – product intended for use in diagnosis, cure, mitigation, treatment or prevention of disease, or intended to affect the structure or any function of the body
 - FDA has approved only one cannabis-related drug – Epidiolex
 - CBD considered illegal by FDA
 - Many states follow the FDA’s position on CBD
 - California – CBD is illegal until FDA changes its position, unless legally sold as a marijuana product
 - FDA enforcement against the low-hanging fruit:
 - Health or medical-related claims
 - Labelling mistakes
 - Marketing mistakes (dietary supplement)

Hemp in the United States

- Hemp-derived synthetic products: Delta 8, Delta 10, HHC, THCV, THCO, HHC
- THCa products
- Hemp-derived Delta 9 products
- Smokable Hemp
 - Not regulated by FDA as a “tobacco product,” but could be regulated by FDA as a “drug”
 - Virtually impossible for law enforcement to distinguish from marijuana without testing
 - Not legal in many states:
- Legality of hemp-derived products still requires a state-by-state analysis as evident by:

Cannabis Financing

SEC and FINRA have been highly scrutinizing and warning about cannabis finance offerings.

- August 2013
 - FINRA News Release, *FINRA Warns Investors of Marijuana Stock Scams*
 - Warns investors to watch out for cannabis investment pitches through faxes, emails, text messages, webinars, infomercials, tweets or blog posts.

Cannabis Financing

SEC and FINRA Scrutiny (continued)

- May 2014
 - SEC Investor Alert, *Marijuana-Related Investments*
 - Announced trading suspensions for common stock of 5 companies operating in the cannabis industry.
 - “Fraudsters often exploit the latest innovation, technology, product, or growth industry – in this case, marijuana – to lure investors with the promise of high returns.”
 - Warning signs of potential investment scams:
 - Guaranteed high investment returns.
 - Unsolicited offers, including through social media.
 - Pressure to buy immediately.
 - No net worth or income requirements.

Cannabis Financing

SEC and FINRA Scrutiny (continued)

- September 2018
 - SEC Investor Alert, *Investor Alert: Marijuana Investments and Fraud*
 - Reiterates warning signs of scams from prior investor alert.
 - Warns of potential for market manipulation from cannabis companies trading on public markets:
 - NYSE
 - Nasdaq
 - Toronto Stock Exchange (TSX)
 - Canadian Stock Exchange (CSE)

Cannabis Financing

Cannabis Stocks on the Public Markets:

- Marijuana became federally legal in Canada in 2018.
 - Significantly changed the way in which cannabis businesses raised capital.
 - Federal legality resulted in Canadian exchanges (TSX and CSE) opening to cannabis businesses.
- Gold rush of Canadian and U.S.-based cannabis companies listing shares on Canadian public markets.
 - Resulted in false sense of stability and inflated valuations in cannabis industry.
 - Significant decline in Canadian public markets trading activity since 2019.

Cannabis Financing

Cannabis Stocks on the Public Markets (continued)

- Cronos:
 - March 2017: \$2.09 CAD / share
 - March 2019: \$22.35 CAD / share
 - September 27, 2023: \$2.07 CAD / share
- Tilray
 - July 2018: \$33.00 CAD / share
 - October 2018: \$156.00 CAD / share
 - March 2020: \$3.55 CAD / share
 - September 20, 2023: \$2.49 CAD / share

Cannabis Financing

Cannabis Stocks on the Public Markets (continued)

- Acreage Holdings
 - September 2020: \$2.77 CAD / share
 - February 2021: \$7.26 CAD / share
 - September 25, 2023: \$0.29 CAD / share
 - \$2 Billion valuation, \$114.5 Million Revenue in 2020
- TILT
 - December 2018: \$2.49 CAD / share
 - December 31, 2018: \$3.75 CAD / share
 - August 16, 2021: \$0.58 CAD / share
 - Delisted August 16, 2021.

Cannabis Financing

Methods of Financing:

- Public Markets:
 - U.S. cannabis companies on CSE and TSX.
 - Exclusive international (mostly Canadian) companies in US Markets.
 - Reverse takeover of shell company already listed on public markets.
 - Traditional IPO.
 - Asset spinoff.
 - Requires engagement of broker / dealer as underwriter, subject to BSA requirements and FinCEN Guidance.

Cannabis Financing

Methods of Financing (continued)

- Reg. D Private Placements
 - Recommended use of broker / dealer as placement agent, subject to BSA and FinCEN Guidance.
 - Unregistered broker (“finder”) risks.
 - Use of Special Purpose Vehicles (SPVs).
 - Equity, debt or convertible debt.
 - Accredited vs. unaccredited investors.
 - Trading away by registered brokers.

Cannabis Financing

Methods of Financing (continued)

- Start up / Application Capital.
- License Sale / Leasing.
- Other methods of financing:
 - Real estate spinoff.
 - Intellectual property spinoff.
 - Licensing.
 - MSO Expansion.

Cannabis Financing Gone Bad

Common ways cannabis business fail

- Under capitalized.
- Inexperienced cannabis personnel.
- Inexperienced management team.
- Unreasonable expectation of returns.
- Desperation capital raising.
- Brokers.

U.S. Code § 280E

“No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.”

(Added Pub. L. 97–248, title III, § 351(a), Sept. 3, 1982, 96 Stat. 640.)

§ 280E – The Basics

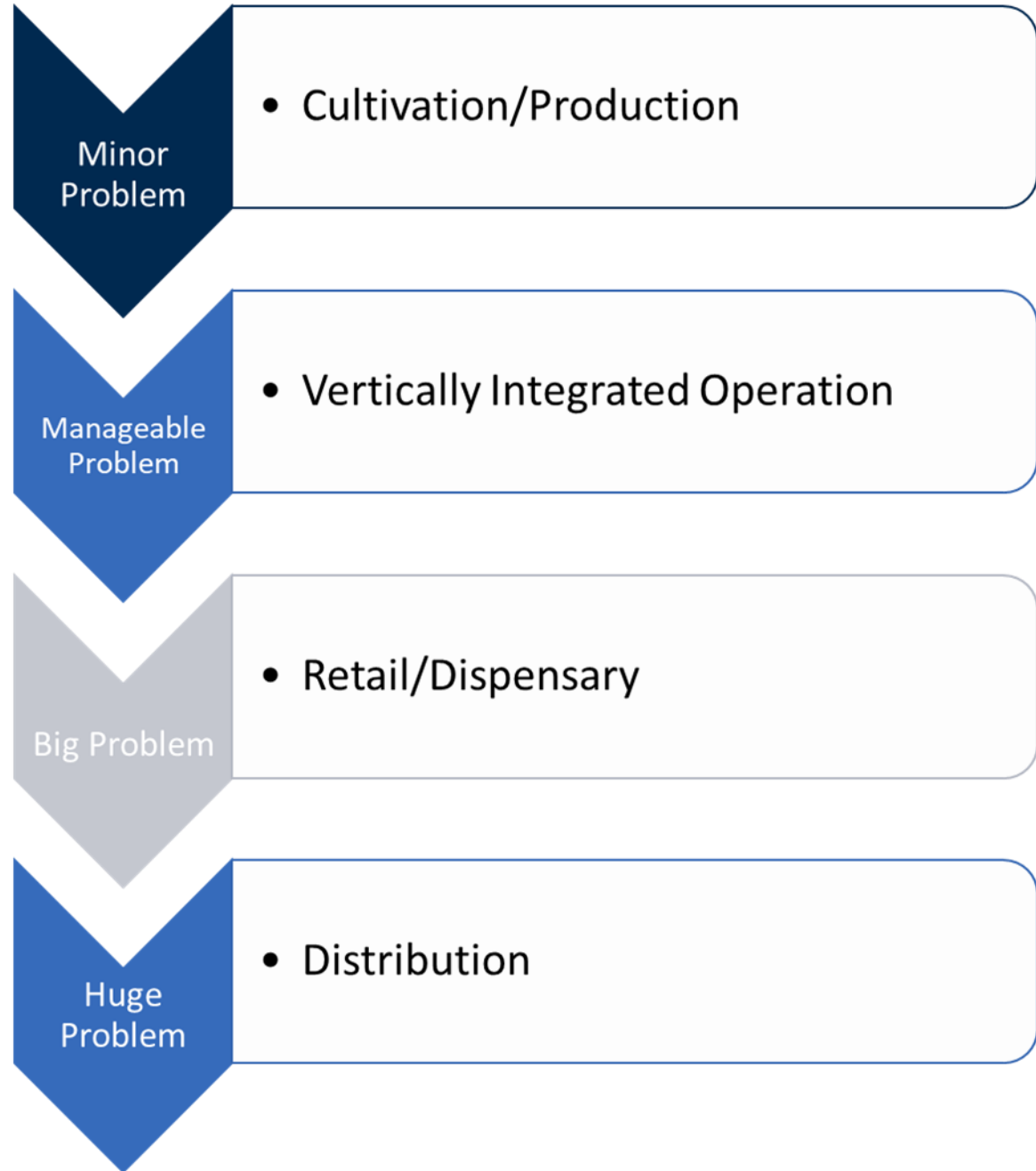
Section 280E of the IRC prohibits cannabis growers, processors, distributors, and retailers from deducting otherwise ordinary and necessary business expenses (“non-COGS business expenses”) from the gross income associated with the “trafficking” of Schedule I or II controlled substances.

Cannabis businesses often pay effective tax rates that are 70% or higher which creates challenges to the industry and inhibits growth of the market.

§ 280E The practical impact

| | 280E Limited | Non-280E Limited | Illicit Market |
|---|--------------|------------------|----------------|
| Sales | 2,000,000 | 2,000,000 | 2,000,000 |
| Cost of Goods Sold | 1,000,000 | 1,000,000 | 1,000,000 |
| Gross Margin | 1,000,000 | 1,000,000 | 1,000,000 |
| General and Administrative Costs | 700,000 | 700,000 | 700,000 |
| Taxable Income | 1,000,000 | 300,000 | 300,000 |
| Pre -Tax Cash Flow | 300,000 | 300,000 | 300,000 |
| Federal Corporate Tax | 210,000 | 63,000 | - |
| Effective Tax Rate | 70% | 21% | 0% |
| Post- Tax Cash Flow | 90,000 | 237,000 | 300,000 |
| *Assumed Federal Corporate Tax Rate = 21% | | | |
| *Does not include state tax expense | | | |

*§ 280E –
Impact varies by
operation*



Cannabis Financing Gone Bad

Illegal cannabis financing examples:

- *SEC v. Cone and Greenview Investment Partners, L.P.*
- *SEC v. Bud Genius*
- *SEC v. Miller*
- *SEC v. Fortitude Group*
- *SEC v. Strategic Global Investments*
- *In the Matter of Fusion Pharm*
- *SEC v. Notis Global*
- *SEC v. Galas*
- *In the Matter of Henry Lin-Han*
- *In the Matter of Artemus Mayor*

Cannabis Financing Gone Bad

Illegal cannabis financing examples:

- *SEC v. WeedGenics*
 - \$60 Million raised
 - Majority of investor capital used to fund extravagant persona lifestyle.
 - Guaranteed returns of up to 36% through investment contracts similar to notes.
 - Owner used fictitious name.
 - Claimed to own cannabis licenses and facilities not actually owned.

Cannabis Financing Best Practices

Best practices for raising capital for your cannabis business

- Use experienced professionals: attorney; accountant; and investment bankers.
- Disclose, disclose, disclose!!!
- Prepare for due diligence.
- Accredited investors only.
- Fully vet investors.
- Do not use unregistered brokers.
- Do not use brokers trading away from their firms.
- Obtain insurance where possible: E&O and D&O.
- Avoid Canadian IPO exit strategy.
- Do not rely on future federal legalization.

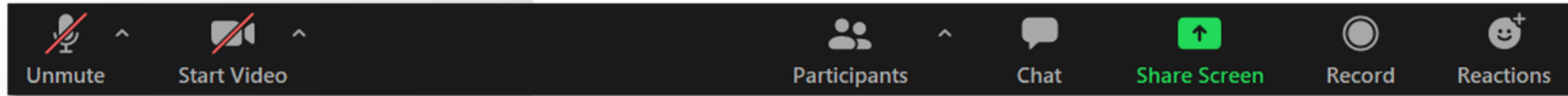
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