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Banking on the Green Rush: Financial Institutions Face New Challenges in Serving the Legal Marijuana Industry

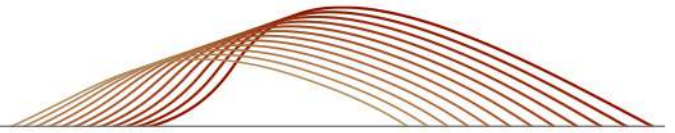
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I. Introduction

Financial institutions that either serve, or seek to serve, marijuana-related businesses face significant uncertainty with respect to marijuana's legal status under state and federal law. As sections of the cannabis industry seek to migrate from black markets to legal markets due to changes in state law, the legalization of marijuana is expected to generate substantial value for industry business owners and the economy. Thus far, financial institutions have been slow to serve the growing legal marijuana industry, but the tide may be turning. On the heels of positive guidance issued by both the Department of Justice ("DOJ") and the Financial Crimes Enforcement Network ("FinCEN"), some financial institutions appear willing to dip their toes into the growing pool of small business customers operating in the marijuana industry.

As of September 2015, twenty-three states and the District of Columbia have legalized some form of marijuana.¹ Colorado alone has approximately 1,200 licensed marijuana businesses, and there are an estimated 2,000 medical dispensaries and retail shops throughout the United States.² These businesses are expected to generate at least \$10 billion in economic value in 2015, and another \$30 billion each year for state and local economies by 2019.³ Despite this remarkable growth, marijuana remains a controlled substance under federal law and federal regulations have generally prohibited financial institutions from serving the industry. As a result, many financial institutions are hesitant to extend even the most basic financial products and services to those in state-legalized marijuana markets. This has left many small business owners without access to cash management resources, checking accounts, merchant and payroll services, remote deposit, bill payment, and Automated Clearing House ("ACH") credit transfers.

Earlier this year, access to these financial products and services seemed inevitable for Colorado business owners, as state banking officials approved a charter for Denver-based Fourth Corner Credit Union—the first credit union seeking to provide financial services specifically for the cannabis and hemp industry. However, the Federal Reserve's recent refusal to approve its master account application and the National Credit Union Administration's ("NCUA") denial of federal share insurance has slowed that forward momentum. Proposed federal legislation has also remained relatively



stagnant,⁴ and financial institutions are left to weigh the current risk of enforcement with the potential reward of acquiring new customers and accounts from a blossoming industry.

II. Unmet Banking Needs of State-Licensed Marijuana Businesses

Financial institutions currently provide few, if any, services to state-licensed marijuana businesses given the substance's current federal legal status. Many banks remain wary of federal scrutiny or prosecution for aiding illegal drug activity should they allow these businesses to open accounts, receive loans, or utilize their credit cards or electronic funds transfer systems. Of the 13,118 banks, savings and loan associations, and credit unions currently operating in the United States, only an estimated 105 banks and credit unions currently service the cannabis industry.⁵ With a less than one percent service rate, many of these businesses are foreclosed from accepting debit cards, credit cards, checks, or mobile payments from their customers. This, in turn, has forced a majority of state-licensed businesses to deal primarily on a cash basis.

Beyond the risk of robbery, skimming and theft, tax evasion, and other types of fraud inherent in an all-cash economy, the absence of financial services has restricted the overall growth of the market. Sellers can keep only so much currency on-site before banking workarounds and alternative and secure cash storage become insufficient. Problems associated with payments to employees and vendors, as well as a lack of clarity in accounting and auditing procedures, also underscore the difficulty of operating these businesses under a framework of opposing state and federal law.⁶

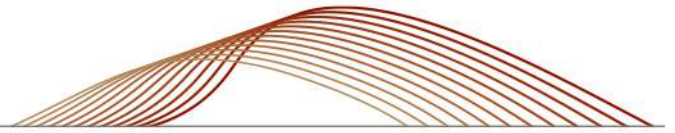
For this reason, the inability of marijuana businesses to open bank accounts has become a growing point of contention between state and federal regulators. For example, Colorado politicians have attempted to bring clarity to the issue by sponsoring bills in both the House and the Senate, and the Senate Appropriations Committee recently approved a measure that would allow banks to provide financial services to state-legalized marijuana dispensaries.⁷ Despite this movement, significant federal barriers remain, and financial institutions are left to monitor the ever-changing landscape of marijuana banking legislation and regulation for insight on how these issues might be resolved moving forward.

III. Federal Legal Barriers and Changing Enforcement Priorities

Even in those states where the sale of marijuana is legal, significant federal deterrents remain for financial institutions interested in serving the industry. Financial institutions that engage with marijuana-related businesses face a range of regulations and potential violations of the Controlled Substance Act ("CSA"),⁸ the Bank Secrecy Act ("BSA"),⁹ the Racketeer Influenced and Corrupt Organizations Act ("RICO"),¹⁰ certain provisions of the USA Patriot Act, and other federal statutes. The recent refusal of master accounts and federal deposit insurance for financial institutions seeking to engage with state-legalized marijuana businesses has made entry into the market even more difficult.

A. Federal Classifications and Reporting Obligations

Perhaps most notably, it remains illegal under federal law to manufacture, distribute, or dispense marijuana.¹¹ The CSA still defines marijuana as a Schedule 1 narcotic alongside heroin, ecstasy, opiates, opiate derivatives, and hallucinogenic substances.¹² This Schedule 1 classification has largely deterred financial institutions from engaging with marijuana businesses, for fear that federal regulators and law enforcement authorities might impose large fines or other punishment for "aiding and abetting" a criminal enterprise. Moreover, RICO defines most violations of the CSA as "racketeering activity,"¹³ and those who conduct or conspire to assist such enterprises could be subject to the severe criminal sanctions and civil liability that RICO imposes as well.



Due diligence and federal reporting requirements place an additional burden on financial institutions that are subject to the BSA, which requires the monitoring of customer accounts for suspicious activity related to money laundering and other financial crimes.¹⁴ FinCEN enforces the BSA and requires financial institutions to also file suspicious activity reports (“SARs”) for account holders that they know or suspect are engaged in illegal activity.¹⁵ Regardless of any state law legalizing marijuana-related activity, a financial institution is still required to file a SAR if it knows, suspects, or has reason to suspect that a transaction conducted or attempted by, at, or through the financial institution: (1) involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity; (2) is designed to evade regulations promulgated under the BSA; or (3) lacks a business or apparent lawful purpose.¹⁶

B. Unavailability of Master Accounts and Deposit Insurance

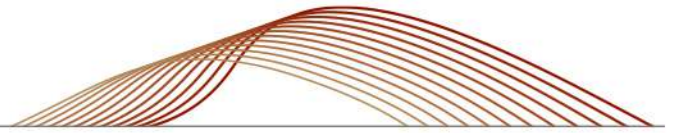
Certain financial institutions may open a master account with the Federal Reserve subject to the discretionary approval of a Reserve Bank. These accounts serve as the institution’s bank account with a Reserve Bank branch and allow for the conversion of cash deposits into electronic credits. Banks and credit unions generally need a master account to operate, and approval is typically granted once an entity obtains a valid charter and routing numbers. Banks, savings and loan associations, and credit unions must also obtain some form of deposit insurance. At present, neither the FDIC nor the NCUA have approved applications for deposit insurance submitted by financial institutions planning to service only marijuana-related businesses. The FDIC and the NCUA may be reluctant to provide deposit insurance to these entities for a number of reasons, including (1) the risk of federal legal action, and (2) the inherent lack of industry diversity, which also increases the risk of failure. Financial institutions who are unable to obtain deposit insurance from the FDIC or the NCUA may, as an alternative, seek private insurance, though those applications might also be denied.

C. Justice Department Guidance

The DOJ and FinCEN have attempted to clarify their enforcement priorities with respect to state-legalized marijuana operations. As discussed below, the DOJ has indicated that it will not target legal marijuana businesses as long as they meet certain regulatory requirements. FinCEN has also released a letter identifying its BSA expectations for financial institutions seeking to provide services to marijuana-related businesses. Although these measures are meant to provide banks and other financial institutions with some guidance for doing business in the industry, no comprehensive guidelines or policies have emerged to mitigate ongoing banking concerns.

In a memo issued by Deputy Attorney General James M. Cole in February 2014 (the “Cole Memo”), the Justice Department summarized its guidance to federal prosecutors regarding eight enforcement priorities for marijuana-related financial crimes under the CSA.¹⁷ Those enforcement priorities include the following:

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;



- Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.¹⁸

As the Cole Memo makes clear, marijuana-related conduct that implicates one or more of the above enforcement priorities will serve as the primary consideration for prosecution under the CSA.¹⁹ Thus, “if a financial institution or individual offers services to a marijuana-related business whose activities do not implicate any of the eight priority factors, prosecution for these offenses may not be appropriate.”²⁰

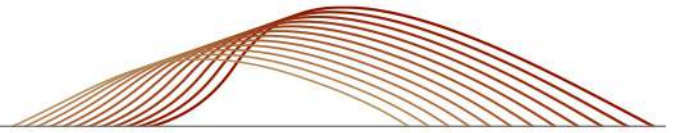
Of course, these enforcement priorities do not foreclose authorities from prosecuting financial institutions for other marijuana-related activities. The DOJ has emphasized that the various federal laws targeting marijuana-related conduct still remain in effect, and as a result, “[f]inancial transactions involving proceeds generated by marijuana-related conduct can form the basis for prosecution under the money laundering statutes (18 U.S.C. §§ 1956 and 1957), the unlicensed money transmitter statute (18 U.S.C. § 1960), and the BSA. Sections 1956 and 1957 of Title 18 make it a criminal offense to engage in certain financial and monetary transactions with the proceeds of a ‘specified unlawful activity,’ including proceeds from marijuana-related violations of the CSA.”²¹ Similarly, “transactions by or through a money transmitting business involving funds ‘derived from’ marijuana-related conduct can also serve as a predicate for prosecution under 18 U.S.C. § 1960.”²² Finally, “financial institutions that conduct transactions with money generated by marijuana-related conduct could face criminal liability under the BSA for, among other things, failing to identify or report financial transactions that involved the proceeds of marijuana-related violations of the CSA.”²³

D. FinCEN Guidance

As discussed above, FinCEN also enforces the BSA and requires financial institutions to monitor their customer accounts for suspicious activity related to money laundering and other financial crimes.²⁴

A February 2014 FinCEN guidance letter clarifies BSA expectations for financial institutions seeking to provide services to marijuana-related businesses, and seeks to “enhance the availability of financial services for, and the financial transparency of, marijuana-related businesses.”²⁵ As the letter notes, “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. These factors may include its particular business objectives, an evaluation of the risks associated with offering a particular product or service, and its capacity to manage those risks effectively. Thorough customer due diligence is a critical aspect of making this assessment.”²⁶

Pursuant to FinCEN’s guidance, financial institutions should engage in customer due diligence that includes the following actions: (1) verifying with the appropriate state authorities whether the business is duly licensed and registered; (2) reviewing the license application (and related



documentation) submitted by the business for obtaining a state license to operate its marijuana-related business; (3) requesting from state licensing and enforcement authorities available information about the business and related parties; (4) developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (*e.g.*, medical versus recreational customers); (5) ongoing monitoring of publicly available sources for adverse information about the business and related parties; (6) ongoing monitoring for suspicious activity, including for any of the red flags described in FinCEN guidance; and (7) refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.²⁷

Financial institutions providing financial services to marijuana-related businesses are required to file a SAR for each of the following categories:

- A Marijuana Limited SAR must be filed if the financial institution reasonably believes, based on its customer due diligence, that the business does not implicate one of the eight federal priorities for enforcement or violate state law;
- A Marijuana Priority SAR must be filed if the financial institution reasonably believes, based on its customer due diligence, that the business does implicate one of the eight federal enforcement priorities or violates state law; and
- A Marijuana Termination SAR must be filed if the 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.²⁸

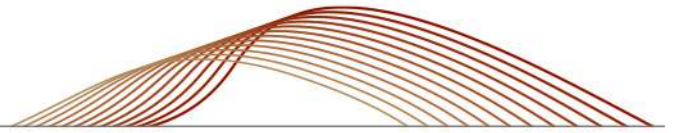
It is important to note that the filing of any of these marijuana-specific SARs could raise additional issues for a financial institution, as the content of a report could be treated as an admission of wrongdoing and potentially lead to enforcement under the provisions of the money laundering statutes, unlicensed money remitter statute, or the BSA. Even if the risk of serious civil and criminal liability is not enough to deter financial institutions from engaging with the marijuana marketplace, additional federal legal barriers—including the unavailability of master accounts from the Federal Reserve or deposit insurance from the FDIC or the NCUA—have made the taking of deposits or opening of new accounts extremely difficult.

IV. Other Movement in the Marketplace

A. Fourth Corner Litigation

The first financial institution created specifically for servicing the marijuana industry, Fourth Corner Credit Union, received its charter from Colorado banking regulators on November 19, 2014.²⁹ Soon thereafter, the credit union applied for a master account from the Federal Reserve Bank of Kansas City—the first application submitted by a financial institution seeking to cater specifically to the hemp and cannabis industry. After months of deliberation and back-and-forth with the Federal Reserve Bank of Kansas City, Fourth Corner’s application for a master account was formally denied on July 16, 2015. This denial followed on the heels of the NCUA’s refusal to approve Fourth Corner’s application for federal share insurance.

In response to these denials, Fourth Corner has filed a lawsuit in federal court, demanding “equal access to the Federal Reserve payments system on nondiscriminatory terms.”³⁰ The Fourth Corner suit places a spotlight on the growing chasm between state laws legalizing some form of marijuana sales



and the federal laws that oppose them. As the issue works its way through the federal court system, financial institutions with an existing master account and deposit insurance are left to assess the likelihood of potential regulatory enforcement and high compliance costs should they enter the marketplace. Though traditional banks may find the risk of doing business with marijuana-related entities too great to justify the addition of several million dollars in deposits, credit unions—many of which serve community members who have been denied traditional banking services—may be poised to benefit from the advent of marijuana banking.³¹

B. Compliance Costs Shutting Out Community Banks

Community banks have also attempted to enter the market, but high compliance costs and pressure from federal regulators have made that road a difficult one. For example, in January 2015, MBank—an FDIC-insured community bank based in Portland, Oregon—began offering its services to marijuana-based businesses in several states, including Oregon, Washington, and Colorado.³² Services included checking accounts, payroll accounts, internet banking, debit cards, and armored car cash pickups.³³ However, one week after opening its doors to Colorado marijuana industry customers, MBank pulled out. CEO Jef Baker cited a lack of infrastructure to support the “overwhelming” amount of customer interest generated by their Colorado services; however, some claim that pressure from federal banking regulators and the continuing risk of working with an illegal industry likely prompted MBank’s pullback.³⁴ By April 2014, MBank dropped all of its cannabis-related clients. Baker explained that MBank simply did not have the “resources necessary to manage the compliance” required for any accounts with legal marijuana-related businesses.³⁵

C. New Marijuana Cooperative Banking Systems

In May 2014, Colorado Governor John Hickenlooper signed Colorado House Bill 1398, the Marijuana Financial Services Cooperatives Act, opening the door for the creation of uninsured marijuana cooperatives “designed to give pot businesses a way to access basic banking services.”³⁶ These marijuana financial services cooperatives (or “cannabis credit co-ops”) are designed to serve as a type of financial services entity with membership that is restricted to entities that are licensed to own or operate a marijuana business.³⁷ While the Act allows cannabis credit co-ops to form, they must still seek permission from the Federal Reserve to access checking and merchant services.³⁸ Given the recent denial of Fourth Corner’s master account application, approval from the Federal Reserve for these co-ops may depend on how the court reacts to the Fourth Corner lawsuit.

D. New Payment Platforms

Some entrants into the marijuana financial services industry are looking to create new payment platforms, rather than establishing full-service banks or expanding their existing services to marijuana industry customers. Kind Financial, a California-based company that is in the process of launching a payment platform specifically for the cannabis industry, hopes to eliminate cash transactions and allow businesses to accept Kind Pay via a mobile phone app or specialized debit card.³⁹ Kind Financial Founder and CEO, David Dinenberg, has also expressed interest in partnering with banks to offer accounts to marijuana-related businesses.⁴⁰ Until then, Kind Financial has been keen to expand its presence in the market. Its recent acquisition of a cloud-based, seed-to-sale software company will allow Kind Financial to track a plant’s growth and movement between sellers, and ultimately, better control “individual transactions in the industry.”⁴¹



V. Action Items

Federal regulation and enforcement surrounding the provision of financial products and services to marijuana-related businesses remains in a state of flux. Recent DOJ and FinCEN guidance may provide some comfort to financial institutions seeking to engage with the market; however, as the Cole Memo notes, nothing in the Justice Department's guidance "precludes investigation or prosecution, even in the absence of any one of the factors listed above, in particular circumstances where investigation and prosecution otherwise serves an important federal interest."⁴² Financial institutions should also note that the DOJ and FinCEN guidance is not legally binding, and a state attorney general or federal prosecutor could pursue banks even if their activities fall outside the enforcement priorities of the DOJ. This possibility could stymie the growth of the industry as financial institutions remain unwilling to jeopardize their positive relationship with federal regulators.

Despite the risk, financial institutions may see great benefit to engaging with the market while the dust still settles—early entrants have an opportunity to capture a significant portion of the loan and deposit market. Based on the current regulatory environment, financial institutions interested in offering their products and services to legal marijuana-based businesses should be proactive about monitoring their internal compliance procedures. Of particular note are the following action items:

- Obtain the required charter approval and deposit insurance in the jurisdiction in which the financial institution intends to operate;
- Maintain a strong and well-funded compliance management and review system that includes monitoring for marijuana-related business transactions;
- Implement a process to ensure compliance with the Cole Memo;
- Review current anti-money laundering and customer due diligence procedures to ensure compliance with FinCEN guidance and the accompanying SAR report requirements; and
- Actively monitor legal developments and engage counsel to help navigate the changing regulatory environment.

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Paul Hastings LLP

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¹ Matt Richtel, *First Bank of Bud*, New York Times (Feb. 5, 2015), available at <http://www.nytimes.com/2015/02/08/business/marijuana-industry-in-colorado-eager-for-its-own-bank-waits-on-the-fed.html>.

² *Id.*

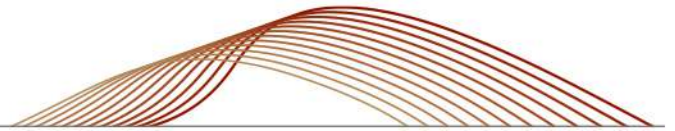
³ Becky Olson, *Exclusive Chart: Marijuana Industry to Create \$10B+ Economic Impact in 2015, \$30B By 2019*, Marijuana Business Daily (May 4, 2015), available at <https://mjbizdaily.com/exclusive-chart-marijuana-industry-create-10b-economic-value-2015-30b-2019/>.

⁴ In July 2015, Colorado Senators Michael Bennet and Cory Gardner introduced the Marijuana Businesses Access to Banking Act, legislation that would open up banking services to state-legal marijuana businesses. A similar bill was introduced in the House of Representatives in July 2013. That legislation, titled the Marijuana Businesses Access to Banking Act of 2013, sought to prohibit a federal banking regulator from, among other things: (1) terminating or limiting the deposit insurance of a depository institution solely because it either provides or has provided financial services to a marijuana-related legitimate business; or (2) prohibiting, penalizing, or otherwise discouraging a depository institution from providing financial services to a marijuana-related legitimate business.



The bill has seen no movement since its referral to the Subcommittee on Crime, Terrorism, Homeland Security, and Investigations in September 2013.

- ⁵ Jennifer Mann, *Chart of the Week: The Challenging Banking Climate for Marijuana Businesses*, Marijuana Business Daily (Jan. 12, 2015), available at <http://mibizdaily.com/chart-of-the-week-snapshot-of-the-challenging-banking-situation-facing-marijuana-businesses/>; Remarks of Jennifer Shasky Calvery, Director of FinCEN (Aug. 12, 2014), available at http://www.fincen.gov/news_room/speech/pdf/20140812.pdf (noting that “there are currently 105 individual financial institutions from states in more than one third of the country engaged in banking relationships with marijuana-related businesses”).
- ⁶ Jeffrey Stinson, *States Find You Can’t Take Legal Marijuana Money to the Bank*, Pew Charitable Trusts (Jan. 5, 2015), available at <http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CB8QFjAA&url=http%3A%2F%2Fwww.pewtrusts.org%2Fen%2Fresearch-and-analysis%2Fblogs%2Fstateline%2F2015%2F1%2F5%2Fstates-find-you-cant-take-legal-marijuana-money-to-the-bank&ei=mu1IVYmnNbOwsATZ8YCQCg&usq=AFQjCNE9IV1y5WYmS5W2gva3A4TbIYTXtQ&bvm=bv.92291466.d.cWc>.
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- ⁸ 21 U.S.C. §§ 801 *et seq.*
- ⁹ 12 U.S.C. § 1829b; 12 U.S.C. §§ 1951-1959e; 31 U.S.C. §§ 5311 *et seq.*
- ¹⁰ 18 U.S.C. §§ 1961 *et seq.*
- ¹¹ 21 U.S.C. § 841; 21 U.S.C. § 812 Schedule I(c)(10).
- ¹² 21 U.S.C. § 812 Schedule I(c)(10); DEA, *Drug Schedules*, <http://www.dea.gov/druginfo/ds.shtml> (last visited May 4, 2015).
- ¹³ 18 U.S.C. § 1961(1)(D).
- ¹⁴ See 31 U.S.C. §§ 5311–5330.
- ¹⁵ See 31 C.F.R. B §§ 103.12–103.30.
- ¹⁶ See, e.g., 31 CFR § 1020.320; FinCEN, *BSA Expectations Regarding Marijuana-Related Businesses 3* (Feb. 14, 2014), available at http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf.
- ¹⁷ U.S. Department of Justice, *Guidance Regarding Marijuana Related Financial Crimes* (Feb. 14, 2014), available at [http://www.justice.gov/sites/default/files/usao-wdwa/legacy/2014/02/14/DAG%20Memo%20-%20Guidance%20Regarding%20Marijuana%20Related%20Financial%20Crimes%202%2014%2014%20\(2\).pdf](http://www.justice.gov/sites/default/files/usao-wdwa/legacy/2014/02/14/DAG%20Memo%20-%20Guidance%20Regarding%20Marijuana%20Related%20Financial%20Crimes%202%2014%2014%20(2).pdf)
- ¹⁸ *Id.* at 1.
- ¹⁹ *Id.* at 1–2.
- ²⁰ *Id.*
- ²¹ *Id.*
- ²² *Id.*
- ²³ *Id.*
- ²⁴ See 31 U.S.C. §§ 5311–5330.
- ²⁵ FinCEN, *BSA Expectations Regarding Marijuana-Related Businesses* (Feb. 14, 2014), available at http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf.
- ²⁶ *Id.* at 2.
- ²⁷ *Id.* at 2–3.
- ²⁸ FinCEN, *BSA Expectations Regarding Marijuana-Related Businesses 3–5* (Feb. 14, 2014).
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- ³⁰ Complaint, *Fourth Corner Credit Union v. Fed. Reserve Bank of Kansas City*, No. 1:15-cv-01633, at ¶ 118 (D. Colo. July 30, 2015).



- ³¹ See, e.g., Marguerite Arnold, *Marijuana Banking Blossoms: O Bee Credit Union Goes “Green” By Targeting Pot Customers*, MainStreet (May 5, 20), available at <https://www.mainstreet.com/article/marijuana-banking-blossoms-o-bee-credit-union-goes-green-by-targeting-pot-customers/page/4>.
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- ³³ *Id.*
- ³⁴ David Migoya, *MBank Pulls Out of Colorado a Week After Taking on Cannabis Accounts*, Denver Post (Jan. 26, 2015), available at http://www.denverpost.com/business/ci_27398018/mbank-pulls-out-colorado-week-after-taking-cannabis.
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