Compliance Issues with Cannabis Company Investments

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I. Introduction

Although most U.S. states are pushing towards legalizing marijuana for at least some uses, the United States federal government has not followed suit. Marijuana is still classified as a Schedule I controlled substance under the federal Controlled Substances Act ("CSA"). Other countries around the globe, like Canada, have fully legalized it. As a result, an entire legal marijuana industry has formed wherein cannabis companies[1] are traded over various public exchanges around the world. Brokers, investment advisers, and their clients may not always fully appreciate the risks associated with investing in the nascent cannabis industry. Compliance officers must be aware of the potential pitfalls these investment opportunities present in order to educate their firms and to help their firms avoid falling into them. While this article mainly focuses on the potential legal risks regarding publicly traded cannabis equities, there are other risks compliance officers should keep in mind when advising their firms such as public perception and meeting the firm's fiduciary duties.

Fortunately for compliance officers, avoiding certain types of investments can significantly reduce certain risks associated with cannabis investing. The most glaring compliance danger is posed by that of investment target companies that "touch the flower" (*i.e.* cultivate, process, manufacture, distribute, or sale marijuana) in the United States. Advisers should consider potential legal risks associated with investing in such companies while marijuana is federally illegal. If companies engage in flower touching operations outside of the U.S., procedures should be in place to verify the company's activity is legal in the jurisdiction in which it operates prior to investment.

As explained in more detail below, U.S. federal drug and money laundering laws may not be implicated with an investment into cannabis companies if the company is listed on a Compliant Exchange.[2] Investments in cannabis companies listed on a Compliant Exchange are generally viewed to be lower risk and typically require minimal additional scrutiny. However, this is not to say investments in cannabis securities that are available on other exchanges should be avoided entirely. The U.S. Department of Justice ("DOJ") has not shown any interest in prosecuting individuals for investments they make into cannabis companies legally operating in their applicable jurisdiction, including, but not limited to, those who are not listed on a Compliant Exchange.

The operative federal laws are the CSA, 21 U.S.C. § 801, *et seq*., the Money Laundering Control Act, 18 U.S.C. § 1956 (the "MCA"), and the Drug Paraphernalia Law[3] ("DPL") contained within the CSA. This article will explain why companies that participate in the cannabis industry outside of the U.S. and are listed on Compliant Exchanges do not violate these laws. Investments in cannabis companies listed on other exchanges can still be made but they pose greater risks. This article will also analyze the Compliant Exchanges where cannabis securities are listed and assess whether there are likely to be any legal repercussions for securities purchases made on them. Finally, this article will advise on potential risks associated with investments in cannabis company securities and best practices that compliance officers should consider implementing to mitigate these risks.

1. For the purposes of this article, a cannabis company or cannabis business refers to any entity that derives at least 50% of its revenue from the legal cannabis industry.
2. The term compliant exchange in this Article is defined as only those exchanges that prohibit flower touching companies from listing. While cannabis company securities may be purchased on certain "other" exchanges, the "compliant" exchanges that this Article contemplates and discusses are limited to the exchanges that forbid listing by companies that cultivate, process, sale, manufacture, or distribute marijuana in the U.S. Therefore, references to "compliant" exchanges only refer to the exchanges identified in Section III.A-E and require compliance with U.S. federal drug and money laundering laws, which are as follows: New York Stock Exchange ("NYSE"), NYSE American ("NYSE American"), Nasdaq Stock Market ("Nasdaq"), TSX ("Toronto Stock Exchange"), TSX Venture Exchange ("TSX Venture") and the Australian Securities Exchange ("ASX").
3. 21 U.S.C. § 863.

II. U.S. Law and Enforcement Priorities

A. Type of Conduct Prosecuted by the DOJ.

Federal prosecutors have considerable discretion in deciding who and what they will pursue relating to marijuana business activities and so far, they have not prosecuted investment activities on public exchanges or the compliance officers overseeing that activity. Rather, prosecutors have focused on actions against U.S. growers, producers, and distributors that violate federal or state controlled substance acts.[4]

We have seen no instances of any action by the DOJ against U.S. companies that have invested in legal non-U.S. cannabis companies. For example, Constellation Brands, Inc., a New York-based Fortune 500 company listed on the New York Stock Exchange, recently exercised its warrants to buy shares in Canopy Growth, a leading cannabis producer out of Ontario, bringing Constellation's total investment in Canopy Growth to about $4 billion.[5] Neither the DOJ nor the SEC has taken action against Constellation for this investment.

Based on the relevant case law and guidance, there is no indication that federal prosecutors would enforce the CSA in a manner where it applies to conduct in another country like Canada or where it punishes investments in Compliant Exchanges, such as the TSX. Similarly, there has also not been, to date, any DOJ action against an investor (or the broker who assisted that investor) in a cannabis company traded on a non-compliant exchange, like the Canadian Securities Exchange (the "CSE") (which is commonly referred to in the vernacular as the "Cannabis Stock Exchange").

B. Prosecutorial Guidance.

The DOJ's reluctance to pursue actions related to cannabis company investments originates from former Deputy Attorney General Cole's 2013 memorandum[6] (the "Cole Memo") that advised on the DOJ's priorities regarding enforcement of marijuana related activities. Prosecution of cannabis company security purchases was not one of the Cole Memo's enforcement goals. Rather, the Cole Memo stated: "enforcement of state laws by state and local law enforcement and regulatory bodies should remain the primary means of addressing marijuana-related activity."[7]

However, in January 2018, then Attorney General Sessions issued a new memorandum (the "Sessions Memo") that rescinded the Cole Memo[8] and deferred back to inherent prosecutorial discretion to pursue penalties for marijuana cultivation, distribution, and possession under the CSA and MCA for financial transactions. While the Sessions Memo is still in effect, current Attorney General Barr has stated that he does not "intend to go after parties who have complied with state law in reliance on the Cole Memorandum."[9] As a result, the current DOJ guidance does not prevent federal prosecutors from pursing investment activity in cannabis companies, but prosecutors do not appear eager to do so and have instead concentrated on illegal local and state growers and producers.[10]

4. *See*, e.g., Superseding Indictment, *U.S. v. Hoang*, Case No. 3:17-cr-70, 2017 WL 9855203 (S.D. Iowa); Press Release, U.S. Dep't of Justice, *Washington, D.C. Post Office Manager and Two Letter Carriers Found Guilty of Bribery and Conspiracy to Distribute Marijuana* (Jul. 24, 2017), available https://www.justice.gov/opa/pr/washington-dc-post-office-manager-and-two-letter-carriers-found-guilty-bribery-and-conspiracy.
5. *Constellation Brands exercises Canopy Growth warrants*, REUTERS, (May 1, 2020), https://www.reuters.com/article/us-canopy-growth-stake-constellation/constellation-brands-exercises-canopy-growth-warrants-idUSKBN22D6F4.
6. Memorandum from James Cole, *U.S. Deputy Attorney General, on Guidance Regarding Marijuana Enforcement* (Aug. 29, 2013) available at https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.
7. *Id.*
8. Memorandum from Jeffrey Sessions, *U.S. Attorney General, on Marijuana Enforcement*, (Jan. 4, 2018) available at https://www.justice.gov/opa/press-release/file/1022196/download.
9. See German Lopez, *The Trump administration's crackdown on marijuana legalization might end under Bill Barr*, VOX (Jan 28, 2019), https://www.vox.com/policy-and-politics/2019/1/28/18200982/marijuana-legalization-trump-jeff-sessions-william-barr.
10. *See*, e.g., Superseding Indictment, *U.S. v. Hoang*, Case No. 3:17-cr-70, 2017 WL 9855203 (S.D. Iowa) (criminal charges filed against growers, not investors, related to marijuana production and/or distribution within the states)

C. DOJ Priorities.
There are numerous companies listed on U.S. exchanges that have openly invested in publicly traded Canadian cannabis companies or are either Canadian cannabis companies themselves, such as Tilray Inc. ("Tilray"). Even though Tilray is a U.S. incorporated company that produces medical marijuana in Canada, the DOJ has taken no action against it and the people who run it. Similarly, the SEC has shown no inclination to take action against cannabis companies despite requesting and reviewing registration statements and other disclosure documents from them.[11]

The DOJ has, however, recently scrutinized marijuana company mergers. Since March of 2019, at the direction of Attorney General Barr, the DOJ antitrust division has pushed second-level antitrust reviews of 10 cannabis company mergers.[12] Recent whistleblower claims have alleged the probes were improperly initiated by Barr due to his dislike of the cannabis industry.[13] John Elias, a career DOJ employee, testified that Barr's personal bias against the cannabis industry resulted in 29% of the antitrust department's 2019-merger probes targeting the cannabis industry.[14] While it remains to be seen what becomes of the whistleblower allegations, it is important to consider that there is a potential dislike of the cannabis industry at the top level of the DOJ.

D. The CSA is Inapplicable to Companies Listed on Compliant Exchanges.
It is doubtful that cannabis company securities purchases made on Compliant Exchanges would violate the CSA.[15] The CSA makes it illegal to "knowingly or intentionally manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance . . . ."[16] By definition, manufacture, distribute, and dispense do not include the act of purchasing a security off the secondary market. Therefore, securities purchases should not be an offense that rises to the level of the basic prohibited activity under the CSA.

Although there is a conspiracy element of the CSA, the underlying act must be one of the prohibited substantive offenses for a violation.[17] Prosecutors could potentially allege that securities purchases are a means to aid and abet cannabis companies in violation of U.S. law. To minimize this risk, compliance officers should develop and implement policies and procedures that limit cannabis investments to those offered on Compliant Exchanges. Firms should also conduct initial and ongoing due diligence on the underlying issuers.

E. The DPL Potentially Presents More Supervision Concerns than the CSA.
The DPL prohibits the sale, importation, exportation, or transportation of "drug paraphernalia."[18] "Drug paraphernalia" is defined as any product "primarily intended or designed for use in manufacturing, compounding, converting, concealing, producing, processing, preparing, injecting, ingesting, inhaling, or otherwise introducing into the human body a controlled substance."[19] The crucial phrase in the application of this definition is "primarily intended".[20] A product's *primary* intended use is evaluated on an objective standard and "refers generally to an item's likely use."[21] While the definition of primarily intended is objective the Supreme Court stated that "it is a relatively particularized definition, reaching beyond the category of items that are likely to

11. *See* Letter from Sec. & Exch, Comm'n to Brendan Kennedy, President and CEO of Tilray, Inc. (Apr. 17, 2018), available at https://www.sec.gov/Archives/edgar/data/1731348/000000000018011638/filename1.pdf; *see also* Securities and Exchange Commission, Investor Alert: Marijuana Investments and Fraud (Sep. 5, 2018), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_marijuana.
12. *See* Betsy Swan and Leah Nylen, *DOJ document defends scrutiny of marijuana mergers*, POLITICO (6/24/2020), https://www.politico.com/news/2020/06/24/doj-document-defends-scrutiny-of-marijuana-mergers-338430.
13. *See* Jack Brewster, *Barr's Personal Animus Towards Marijuana Prompted Cannabis Industry Probes, DOJ Whistleblower Says*, FORBES (June 24, 2020), https://www.forbes.com/sites/jackbrewster/2020/06/24/barrs-personal-animus-towards-marijuana-prompted-cannabis-industry-probes-doj-whistleblower-says/#2ac568605432.
14. *See* Caroline Kelly, *DOJ whistleblower to testify that Barr's personal anti-marijuana sentiment fueled cannabis industry investigations*, CNN POLITICS (June 23, 2020), https://www.cnn.com/2020/06/23/politics/elias-testimony-barr-cannabis-trump-automobile-california/index.html.
15. Investments off other stock exchanges have not received DOJ scrutiny either.
16. 21 U.S.C. § 841(a)(1).
17. 21 U.S.C. § 846.
18. 21 U.S.C. § 863.
19. 21 U.S.C. § 863.
20. *See* 21 U.S.C. § 863(d).
21. *Posters 'N' Things, Ltd. v. United States*, 511 U.S. 513, 521 (1994).

be used with drugs by virtue of their objective features." [22] Factors are an items oral or written instructions and how it is displayed.[23] "Thus, while scales or razor blades as a general class may not be designed specifically for use with drugs, a subset of those items in a particular store may be 'primarily intended' for use with drugs by virtue of the circumstances of their display and sale."[24] Items that have a variety of uses, and are not specifically designed to make or consume controlled substances do not qualify as drug paraphernalia without strong evidence indicating otherwise.[25]

As a result, compliance officers should keep in mind that conduct violating the DPL is potentially harder to identify than CSA violations. Additionally, the due diligence for companies manufacturing products potentially controlled by the DPL should be as thorough as it would be for flower touching companies located outside of the U.S.

F. Investment Activities Most Likely Will Not Trigger Money Laundering Laws.
The MCA poses another potential risk that compliance officers must take into consideration. It is a violation of the MCA for:

> [W]hoever, knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such a financial transaction which in fact involves the proceeds of specified unlawful activity - with the intent to promote the carrying on of specified unlawful activity. . .[26]

It is a further violation of the MCA for:

> Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States - with the intent to promote the carrying on of specified unlawful activity. . .[27]

If securities purchases involve companies listed on a Compliant Exchange, the MCA should not pose a concern because money generated from the sale of those securities should not represent proceeds from conduct forbidden by the CSA. Further, we are not aware of any documented case where law enforcement pursued such an investment as in violation of the MCA for companies listed on other exchanges, either.

There is also a conspiracy element to the MCA that subjects offenders to the same penalties as defined under Sections 1956 and 1957.[28] However, a conspiracy to violate the MCA requires that the actor's objective must be to conduct a financial transaction involving the proceeds of a specified unlawful activity.[29] Absent an underlying criminal activity, there cannot be a conspiracy to violate the MCA.[30] If compliance officers adopt policies and procedures limiting securities purchases to companies listed on Compliant Exchanges, it is likely that the proceeds from the underlying investments would not trigger MCA violations. Investing in companies listed on other exchanges, although perhaps riskier, may not likely generate any MCA attention either.

22. *Id.*, at 521 n. 11.
23. *Id.*
24. *Id.*
25. *Posters 'N' Things, Ltd. v. United States*, 511 U.S. 513, 521 (1994).
26. 18 U.S.C. § 1956(a)(1)(A)(i).
27. 18 U.S.C. § 1956 (a)(2)(A).
28. *See* 18 U.S.C. § 1956(h).
29. See *United States v. Garcia*, 587 F.3d 509, 515 (2d Cir. 2009).
30. *See Id.*

III. Where to Make the Less Risky Investment.

It is vital that the policies and procedures adopted by firms account for the risks associated with investing in the various public exchanges. The exchanges that require compliance with U.S. federal securities laws are less risky (albeit not the only) platforms to utilize for cannabis company investments. As noted above, the NYSE and NYSE American, Nasdaq, TSX, TSX Venture, and the ASX have made compliance with the CSA, MCA, and DPL a prerequisite to being listed on such exchange, hence the term used herein of Compliant Exchange, and each may delist companies that do not comply.

In contrast, the CSE does not preclude companies from being listed even if they grow, produce, distribute, or sell marijuana in the U.S., such that investments on this exchange present additional compliance obligations.

The routine enforcement measures the Compliant Exchanges take mitigate the risk of violating the CSA, MCA, or DPL.

IV. Practical Guidelines for Compliance Officers

A. Consider the Exchange on Which the Securities Trade.
As noted above, the less risky exchanges from a compliance and supervision standpoint are the Compliant Exchanges because they all require listed cannabis companies to comply with the CSA, MCA, and DPL and the law of the jurisdiction in which they operate.

B. Mandate Due Diligence Safeguards.
Compliance officers should not merely rely on the safeguards inherent in the Compliant Exchange listing standards; they should conduct their own due diligence prior to permitting recommendations of cannabis securities on a secondary market. Brokers/investment advisers should be required to have a deep knowledge and intimate understanding of the practices and activities of each issuer they recommend. This review should include a thorough review of a company's publicly available information for indications that it engages in any activity that might violate the CSA, DPL or MCA prior to investment and the diligence should be repeated periodically. If ongoing due diligence reveals a violation of the CSA, DPL or MCA, firms should be prepared to have customers divest those positions.

V. Conclusion

While there are many appealing investment opportunities in this rapidly evolving industry, there are also many dangers that investors or broker-dealers may be blind to when they sense a potential opportunity they want to quickly seize. That is, compliance officers must step in and ensure that policies and procedures are in place to address the unique oversight issues discussed above and are properly vetted and researched beforehand. To do so, compliance officers should have a thorough understanding of the line of demarcation that could result in a violation of the law, and craft and enforce preventative guidelines to make sure the individuals they supervise stay behind that line. ■