

A New Initiative Concerning Non-Recreational Cannabis-Related Businesses

ABSTRACT

VIA Folio, the private securities division of Folio Investments Inc., has decided to support capital formation for certain businesses engaged in the cannabis sector. We reached this decision because we believe it will advance our goal of democratizing the private securities sector and will help fund companies that cannot tap traditional venture capital. We began exploring this idea after broker-dealers contacted us about our willingness to support the fundraising efforts of certain cannabis-related businesses.

Prior to reaching a decision, we studied and carefully considered the complex legal landscape and public policy issues surrounding the growing legalization movement for cannabis. Any use of cannabis is currently illegal under federal law. However, with November's election results, medicinal use of cannabis is now permitted under state law in 28 states and the District of Columbia, a region comprising more than 60% of the U.S. population. Adult recreational use of cannabis is now legal in seven states and the District of Columbia, an area comprising more than 20% of the U.S. population. We believe that the effort to decriminalize the use and sale of cannabis will continue and is consistent with public policy reforms seeking to mitigate the harmful impact that cannabis-related arrests and imprisonments have, including on minority communities, where they have had a disproportionate effect.

We have decided to begin our work in this area by supporting two categories of companies whose activities are legal under both state and federal law. Those companies are (1) pharmaceutical companies engaged in research under waivers granted by the Drug Enforcement Administration; and (2) companies that do not "touch the plant" but provide products or services to businesses that do.

We will actively assess developments in this area as they occur and may decide to expand the categories of companies that we have decided to support. We therefore invite companies in categories not described above, specifically companies involved in sales of cannabis for both medical and recreational uses, to contact us to discuss ways that we might assist them in the future.



A New Initiative Concerning Non-Recreational Cannabis-Related Businesses

Introduction

VIA Folio, the private securities division of Folio Investments Inc., is at an inflection point in supporting capital formation in new ways. We believe we can promote investors' interests by democratizing the opportunity to invest in private securities. We can also help support businesses that cannot tap venture capital due to offering size, type of deal or otherwise, and by doing so foster job growth and a new generation of entrepreneurs.

Recently, a number of issuers and intermediaries have asked us whether we would consider supporting offerings of private securities by companies engaged in activities related to cannabis. Specifically, we received requests from other broker-dealers to support offerings for cannabis-related businesses that are their clients, from cannabis-related businesses themselves, and from investors seeking to purchase private securities issued by these businesses. Although reports about the size of the demand for investment in this space vary considerably, it appears clear that some reasonable level of demand currently exists.

After receiving these inquiries, we examined in detail the opportunity to support capital formation for cannabis-related businesses. This document explains our thought process and the position we arrived at. It also serves to solicit any comments you may have about our decision.

Based on our examination, we decided that we can and should support capital raising efforts by private businesses involved in certain cannabis-related areas. Although many states have passed laws legalizing cannabis use at the state level, it remains illegal under federal law for any purpose. For this reason, we have decided at this time to support only those companies that do not handle cannabis or are conducting pharmaceutical research pursuant to waivers granted by the Drug Enforcement Administration. As a result, the activities of the companies we support will not violate federal law, and we will only support companies whose activities are also legal under applicable state law.

The businesses we will support fall into two categories: (1) pharmaceutical companies engaged in research under waivers granted by the Drug Enforcement Administration; and (2) companies that do not "touch the plant" but provide products or services to businesses that do.

We will continue to study this area and may, based on future developments, decide to extend our support to capital-raising activities by companies engaged in additional cannabis-related activities.

Increasing Legalization

Legalization of cannabis at the state level is gaining increasing acceptance. In our view, this trend will continue to build momentum.¹ Observers believe that many states will eventually legalize and regulate cannabis, rather than continue to criminalize it.² Thus far, 28 states and the District of Columbia have legalized cannabis for medicinal use, rendering it available to more than 60% of the U.S. population.³ Seven states and the District of Columbia have legalized cannabis for recreational use, an area that covers more than 20% percent of the U.S. population. Seventeen other states have also decriminalized cannabis.⁴

Harmful Effects of Continued Criminalization

Advocates of legalization argue that it removes the sale of cannabis from dangerous black markets, where it flourishes in uncontrolled settings and may provide funding for criminal enterprises. They also contend that legalization generates a source of general tax revenue,⁵ and that revenue can be used to finance education, research, youth prevention, and public health initiatives, as well as for other general uses.

Legalization advocates also argue that there are significant harmful effects on society due to the continued criminalization of cannabis. Specifically, they point to the expenditure of limited law enforcement resources on criminal enforcement of cannabis laws when those resources could better be spent elsewhere, to the cost and human toll of the incarceration of large numbers of people for cannabis use or possession unassociated with any other crime, and to the disproportionate effects these efforts have had on minority communities.

Advocates cite the example of Illinois, where more than 50,000 arrests occur annually for simple cannabis possession. Of those 50,000 people, a disproportionate number of them are people of color.⁶ Since these statistics were released, Illinois Republican Governor Bruce Rauner signed

¹ See, e.g., “Options and Issues Regarding Marijuana Legalization” <http://www.rand.org/pubs/perspectives/PE149.html>.

² See, e.g., “Clearing Up Misconceptions About Marijuana Rescheduling: What it Means For Existing State Systems,” <https://www.brookings.edu/2016/05/27/clearing-up-misconceptions-about-marijuana-rescheduling-what-it-means-for-existing-state-systems/>.

³ See, e.g., “28 Legal Medical Marijuana States and DC” <http://medicalmarijuana.procon.org/view.resource.php?resourceID=000881>.

⁴ Decriminalization generally means “no arrest, prison time, or criminal record for the first-time possession of a small amount of marijuana for personal consumption.” See <http://norml.org/aboutmarijuana/item/states-that-have-decriminalized>

⁵ See, e.g., “Making an Economic Case for Legalizing Drugs,” <http://www.cato.org/publications/commentary/making-economic-case-legalizing-drugs>.

⁶ See http://salsa3.salsalabs.com/o/51046/p/dia/action3/common/public/?action_KEY=17968; see also “The War on Marijuana in Black and White,” American Civil Liberties Union, June 2013 (available at <https://www.aclu.org/files/assets/1114413-mj-report-rfs-rel1.pdf>), which found that African-Americans were almost four times more likely to be arrested for marijuana possession than whites, even though marijuana usage between the two groups is approximately the same (14% vs. 12%).

into law, on July 29, 2016, legislation that reduces the penalties for possession of up to 10 grams of marijuana from a criminal misdemeanor, punishable by up to six months in jail and a \$1,500 fine, to a civil fine of no more than \$200, meaning there is no longer an arrest or criminal record in Illinois for this offense.⁷

Statistics from New York have also raised concerns about enforcement of cannabis laws in a discriminatory manner. In November 2014, Mayor Bill DeBlasio ordered the New York Police Department to stop arresting people for cannabis possession and instead issue civil citations. Despite his decision, more than 16,000 people were arrested in 2015 for cannabis possession in New York City alone, nearly 90% of them black or Latino.⁸

Medicinal Uses of Cannabis

We also examined the increasing evidence of the effective use of cannabis for medicinal purposes. For some time now, patients have been using medicinal cannabis for a wide range of therapeutic purposes, including pain treatment, nausea, epilepsy, inflammatory diseases, multiple sclerosis, and post-traumatic stress disorder. There are also ongoing trials evaluating cannabis-related pharmaceutical therapies for many serious diseases, including diabetes, cancer, neurodegenerative disorders, and rare, severe, pediatric epilepsies.⁹ And, late last year, the Drug Enforcement Administration eased requirements for FDA-approved clinical trials on certain cannabis-derived drugs.¹⁰ In August, the Drug Enforcement Administration also adopted a new policy to allow an increase in the number of entities permitted to grow cannabis for research.¹¹ Prior to the adoption of the new policy, only one entity was permitted by the federal government to grow cannabis for research.

In terms of activity in the private sector, we note that Microsoft recently announced plans to partner with Kind Financial to provide compliance and reporting services to various cannabis-related businesses.¹²

marijuana usage between the two groups is approximately the same (14% vs. 12%).

⁷ See

<http://www.ilga.gov/legislation/billstatus.asp?DocNum=2228&GAID=13&GA=99&DocTypeID=SB&LegID=93232&SessionID=88#actions>

⁸ <https://www.mpp.org/states/new-york/>

⁹ See, e.g., “Medical Cannabis Has High POTential: A Joint Biotech & Tools Primer,” Bank of America Merrill Lynch Research Report, December 3, 2015.

¹⁰ See <https://www.dea.gov/divisions/hq/2015/hq122315.shtml>

¹¹ See https://www.deadiversion.usdoj.gov/fed_regs/rules/2016/fr0812_3.pdf

¹² See <http://www.nytimes.com/2016/06/17/business/dealbook/microsoft-following-the-clouds-to-offer-marijuana-tracking-software.html?hp&action=click&pgtype=Homepage&clickSource=story-heading&module=second-column-region®ion=top-news&WT.nav=top-news&r=0>

Publicly Traded Cannabis Companies Available Through Folio

Finally, we note that Folio Investments has, for some years now, made it possible for clients to trade shares of U.S. exchange-listed cannabis-related companies. These include, for example: GW Pharmaceuticals ([GWPH](#)), a U.K.-based biotech company which has a cannabis-based epilepsy drug, and Insys Therapeutics ([INSY](#)), an Arizona-based company known for its cancer pain management drug which is also developing a cannabis-based drug for the treatment of epilepsy. Others include Cara Therapeutics ([CARA](#)), a Connecticut-based clinical state biopharmaceutical company that develops pain-relief drugs, and Zynerba Pharmaceuticals ([ZYNE](#)), a Pennsylvania-based company developing and commercializing synthetic cannabinoid therapeutics.

Federal Government Guidance

Despite the trend toward legalization at the state level, cannabis continues to be illegal under federal law for any purpose. Cannabis is currently a Schedule I drug under the federal Controlled Substances Act (along with heroin and LSD).¹³ However, in light of the numerous state laws legalizing cannabis use for both medicinal and recreational purposes, in 2014 the federal government provided guidance about the use of federal investigative and prosecutorial resources for cannabis-related activities in states where those activities are legal, as well as compliance with certain anti-money laundering laws. We note that these policies are not enshrined in law but are instead positions taken by the current administration, and the new administration could of course change them.

In 2014, the U.S. Department of Justice advised federal prosecutors to avoid using their resources for cannabis-related activities that are i) otherwise legal under the applicable state law and ii) do not fall within eight specifically-identified areas of concern.¹⁴ Those eight areas are: (1) preventing the distribution of cannabis to minors; (2) preventing revenue from the sale of cannabis from going to criminal enterprises; (3) preventing the diversion of cannabis to states where it is not legal; (4) preventing state-authorized activity from being used as a cover for the trafficking of other illegal drugs or other illegal activity; (5) preventing violence and the use of firearms; (6) preventing drugged driving and other public health problems; (7) preventing growing of cannabis on public lands; and (8) preventing cannabis possession on federal lands.

The U.S. Department of Treasury also issued guidance, through its Financial Crimes Enforcement Network Bureau (FinCen), regarding compliance with federal anti-money laundering reporting requirements by regulated entities.¹⁵ The guidance provides instructions to financial institutions, such as VIA Folio, about how to comply with the reporting requirements for funds that result

¹³ <http://www.fda.gov/regulatoryinformation/legislation/ucm148726.htm>

¹⁴ See Memorandum from James M. Cole, Deputy U.S. Attorney General, dated August 29, 2013, "Guidance Regarding Marijuana Enforcement," available at <https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf>.

¹⁵ See FinCen Guidance FIN-2014-G001, dated February 14, 2014, "BSA Expectations Regarding Marijuana-Related Business," available at https://www.fincen.gov/statutes_regs/guidance/html/FIN-2014-G001.html.

from cannabis-related activities. It creates a distinction between activities that are both legal under state law and that do not fall within the eight categories enumerated in the guidance provided by the Department of Justice as noted above, and those that are not legal under state law or do fall within any of the eight categories.

Specifically, a regulated entity such as VIA Folio is required to file what is called a “Marijuana Limited” Suspicious Activities Report (SAR), if it receives funds from state-permitted cannabis-related activities that do not fall within one of the eight categories of concern for federal prosecutors. A regulated entity is required to file a “Marijuana Priority” SAR for all other cannabis-related activities.

Consequently, we note and appreciate the fact that the federal government – at least the current administration – has differentiated between and among the various types of activities that it believes should be condoned, or at least permitted – without banning the participation of federally-regulated entities, and instead providing them a roadmap as to how to comply with applicable federal policies.

Our view is that these approaches are reasonable and workable. They recognize the requirements of the current system, specifically the present placement of cannabis as a Schedule I drug under the Controlled Substances Act, but also acknowledge that the states are taking a different approach to regulating cannabis, and then work within that set of legal and contrasting frameworks.¹⁶ As noted, however, these policies are subject to change by the new administration.

Our Conclusions

Cannabis-related businesses generally break down into four categories:

1. **Pharmaceutical:** These are businesses involved in research on cannabis-related or derived products, are *primarily focused on pharmaceutical uses*, and are proceeding through the Federal Drug Administration process and conducting research pursuant to Drug Enforcement Administration waivers (“**pharmaceutical**” uses).
2. **Medicinal:** These are businesses involved in manufacturing, distributing or selling cannabis-related or derived products *that are primarily focused on medicinal uses*, typically where medicinal use is permitted under state law, though still illegal at the federal level. In these states, a doctor can usually provide a medical use certificate or card allowing a patient to obtain cannabis for personal use, but the FDA has not

¹⁶ The Internal Revenue Code also presents issues for cannabis businesses. Section 280E of the Code prohibits companies engaged in “trafficking in controlled substances” under Schedule I and II of the Controlled Substances Act from deducting business expenses from their federal income taxes. For companies selling or distributing cannabis, this provision prevents them from deducting their business expenses, though they are able to deduct costs-of-goods sold. The application of Section 280E therefore presents challenges for businesses engaged in the sale or distribution of cannabis to be profitable.

approved the use and the DEA has not supplied such companies with a waiver (“**medicinal**” uses).

3. **Recreational:** These are businesses involved in the manufacture, distribution or sale of cannabis-related or derived products *for recreational use*. The products they manufacture, distribute or sell include products that contain tetrahydrocannabinol (THC) related compounds that generally are psychoactive (i.e., contribute to a “high”), and cannabidiol (CBD) compounds that are non-psychoactive and used to reduce anxiety, boost wakefulness and have other effects – both of which may be used recreationally (“**recreational**” uses).
4. **Supporting, Non-Plant Businesses:** These are businesses that are not involved in the manufacture, distribution or sale of cannabis-related or derived products but provide products or services that may be used by companies that do. These are often referred to as businesses that “do not touch the plant.” They include firms that fund cannabis-related businesses, firms that make or sell greenhouses, lighting, peripheral equipment, or warehouse facilities primarily designed for use with or whose marketing activities are primarily focused, on cannabis-related businesses, and firms that acquire land for lease to those who grow cannabis, but who otherwise have no connection to the manufacture, distribution or sale of cannabis (collectively, “**non-plant**” uses).

Given the guidance provided thus far by the federal government, we believe we could support capital raising efforts by businesses whose activities are legal under state law but still illegal under federal law, by taking sufficient efforts to assure ourselves that the activities do not implicate any of the concerns raised by the Department of Justice in its guidance. We would also, of course, comply with the reporting requirements set out by the Department of Treasury. This would include companies in the first, second and fourth category above. We are therefore willing to enter into discussions with companies in those categories about ways we might assist them in the future. This assumes of course that the guidance provided by the federal government does not change. If it does, we will need to assess any such changes before deciding how to proceed.

For the present time, we will begin our efforts by supporting companies whose activities are legal at the both the state and federal level. We will support capital raising efforts of businesses in the first category, the **pharmaceutical** category, to the extent those businesses are engaged in research and related activities pursuant to a Drug Enforcement Administration waiver, and businesses in the fourth, or “**non-plant**” category, where the businesses’ primary focus is **other than** recreational use. And we will only support companies whose activities are also legal at the state level. As a result, the activities of the companies we support will not violate state or federal law

However, as the legal landscape relating to cannabis continues to evolve, we will assess whether it is appropriate to change our position and possibly expand the categories of companies we support.

We have communicated with the SEC and FINRA about our plan to engage in these activities, and we will continue to discuss our efforts with them as we go forward. They have told us that, given the current illegality under federal law, they could have concerns if we moved beyond the activities described in this paper, but it is not our intention to do so at this time.

We believe that providing the services of VIA Folio to these companies under the conditions we have established will help us in our efforts to provide innovative financial solutions and transform the way people invest for the better. In doing this, we can stand for how a responsible and established firm serving the interests of investors can, with integrity, thought and a deep respect for the law and regulation, do the right thing from a public policy perspective.

We invite your views on our analysis and our conclusion, and welcome additional perspectives.