

Banking Bad: Financial Services in the Age of Bitcoin and Legalized Marijuana

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1. PowerPoint

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What We Will Cover—

- The Emerging Challenges and Risks to Financial Institutions and Lawyers presented by:
 - Virtual Currencies, and
 - Banking Marijuana Businesses

Virtual Currencies



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Characteristics of Traditional Currency

- Safety and reliability
- Durability
- Portability
- Fungibility
- Liquidity
- Backed by something:
 - Gold or silver (functional elements)
 - Sovereign guarantee
- Timeliness
- Availability of funds to the recipient
- Confirmation of payment authorization (and sale)
- Accessibility and ease of use
- Ease of integration into other processes
- Related data and funds transfer functionality

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Compare to Characteristics of Virtual Currencies

- Not backed by anything tangible or by law
- Exists solely in electronic format with no physically accepted counterpart
 - But “existence” is directly linked to a specific computer or server
- Operates outside of the banking universe
- Initially unregulated (for the most part)
- Issued and controlled by developers
 - But sophisticated investors now placing wagers
- Initially used and accepted in a specific virtual community
- Arguably creates quasi-anonymity

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Bitcoin Specifics

- Currency is created by “mining” – solving complex algorithms
- Currency is stored in virtual wallets – software applications
- Currency is spent using a series of passwords – public and private:
 - Private key is used to authorize the spending of the bitcoin
 - Public key allows for recordation on a transparent decentralized registry — potentially worldwide
- Blockchain is piece of software that is administered by a large group of users that records every bitcoin transaction when it occurs
- See Satoshi Nacamoto’s explanation at:
 - <https://bitcoin.org/bitcoin.pdf>

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User Risks

- Bad reputation from early adopters (*i.e.*, crooks)
- Cannot be affected by government monetary policy
- Not tethered to anything so “value” can fluctuate wildly
 - Frequently compared to commodities or futures
 - January 15, 2015—Bitcoin value drops 22% in one day
 - 80% drop in one year
- Hackers (*i.e.*, password dependent)
- Physical risk of loss (*i.e.*, hard drive crashes)
- Irreversible
- Exchanges undercapitalized and lacking liquidity

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Pros and Cons of Virtual Currencies

- Pros —
 - Technology enthusiasts envision improved payment system
 - May be generational or a passing fad for millennials
 - Enhanced ability to operate anonymously (maybe)
 - Significant reduction in payment transfer fees present in the banking system
 - Potentially a significant retail customer benefit
 - **Virtual instantaneous international payments**
 - Serious investors now placing bets

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Cons — The Dark Web



**Tanks and Drugs
for Sale!!!**

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Cons—Out-and-Out Theft

MTGOX 破産債権届出システム /
MTGOX bankruptcy claims filing system

- Mark Karpeles, the former head of defunct bitcoin exchange Mt. Gox arrested for theft of bitcoin in Japan
 - Allegedly stole hundreds of millions of dollars of bitcoin out of the Mt. Gox Exchange
 - So much for the safety of bitcoin....

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Cons of Virtual Currencies

- Facilitates criminal/illegal transactions
 - Money laundering
 - Sale of prohibited goods
 - Illegal gambling
 - Tax evasion
- Volatility in valuation
- Risk of loss
- Lack of stable, reliable regulatory structure
- Taxable nature of transactions

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Regulatory/Agency Treatment

- FinCEN Guidance—FIN-2013-G001—March 18, 2013
- FinCEN Guidance—FIN-2014-R011—VC trading platform
- FinCEN Guidance—FIN-2014—VC payment system
- IRS Guidance—March 2014
- CFTC order of September 17, 2015
 - Release PR 7231-15
- Department of Treasury Guidance on “legal tender”
- CSBS virtually currency guidance
- State Money Transmitter licensing decisions
 - New York licensing of bitcoin exchange
- California Corporations Code
- FINRA
- SEC

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Practical Legal Issues

- Using virtual currency to qualify a borrower for a loan
 - Representations and warranties
- Using virtual currency as security for a loan
 - Possession or control under the UCC
 - What is the appropriate collateral description?
 - What type of UCC collateral is virtual currency?
- Potential conversion of repayment assets to virtual currencies
 - Loan covenants

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Practical Legal Issues

- Bitcoins may be held individually or by an exchange in a “wallet”
- Commentators believe that bitcoin is likely a “general intangible”
- The challenges to a lender:
 - Create a security interest
 - Perfect the security interest
 - Create a path for recovery
 - If the bitcoin is held by an exchange—causing the exchange to acknowledge the security interest

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Banking Marijuana Businesses



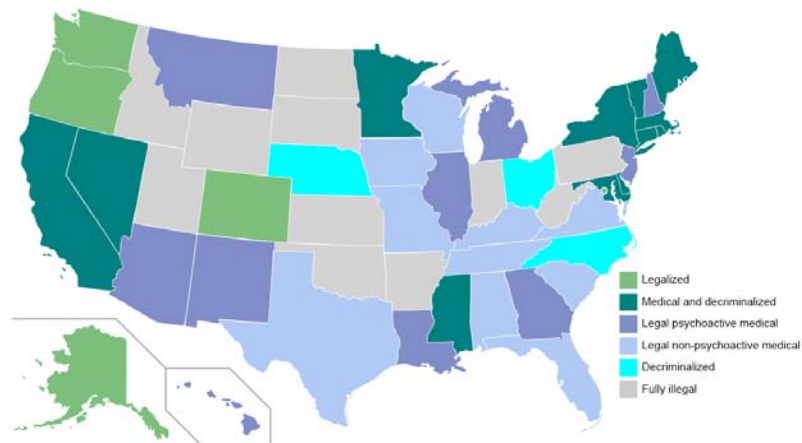
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Source: Marihuana: The Devil's Weed!, Roadshow Attractions Corporation 1936

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Status of marijuana laws in the United States



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Marijuana and Banking – Background

- CSA – Controlled Substances Act
 - Marijuana is a Schedule 1 drug
 - Strict forfeiture and aiding and abetting liability
 - You need to know what this means...
- Cole Memo – August 29, 2013
 - Provides list of CSA enforcement priorities for Department of Justice attorneys and federal law enforcement
 - Bad v. really, really bad activity dichotomy

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Marijuana and Banking – Background

- Cole Memo enforcement priorities:
 - Minors
 - Revenue to criminal enterprises, gangs and cartels
 - Diversion of marijuana from “legal” state to “non-legal” state
 - State-authorized as a pretext for other illegal activity
 - Violence and firearms
 - Drugged driving
 - Marijuana cultivation on public land
 - Possession on federal property

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Marijuana and Banking – Background

- DOJ – Guidance Regarding Marijuana Related Financial Crimes – February 14, 2014
 - “...Title 18 make[s] 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.”
 - “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.”

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Marijuana and Banking – Background

- DOJ – Guidance Regarding Marijuana Related Financial Crimes – February 14, 2014
 - “if a financial institution... provides banking services to a marijuana-related business knowing that the business is [Cole memo priority], prosecution for violations of [the CSA] or the BSA **might** be appropriate.” (emphasis added)
 - Also covers scenarios where the institution is “willfully blind to such activity”

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FinCEN-2014-G001

- BSA Expectations Regarding Marijuana-Related Businesses (“MRBs”)
- “This FinCEN guidance clarifies how financial institutions can provide services to marijuana-related businesses consistent with their BSA obligations . . .”
- “This FinCEN guidance should enhance the availability of financial services for, and the financial transparency of, marijuana-related businesses.”
- Reiterates Cole Memo priorities

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FinCEN-2014-G001

- Risk assessment and due diligence
 - Verify that the business is licensed and registered (general business license)
 - Review license application (and related documents) submitted by the business that is required to operate a marijuana-related business (licenses specific to marijuana operations)
 - Request information about the business and “related parties” from state licensing and enforcement authorities

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FinCEN-2014-G001

- Risk assessment and due diligence
 - Developing an understanding of the normal and expected activity for the business, including the types of products to be sold and type of customers to be served (e.g., medical v. recreational customers)
 - Monitor publicly available sources of information
 - Monitor for suspicious activities (“red flags” in guidance)
 - Refreshing due diligence information on a periodic basis commensurate with risk profile

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FinCEN-2014-G001

- Three new types of Suspicious Activity Reports (“SARs”)—



Cheech and Chong SARs

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FinCEN-2014-G001

- Marijuana Limited – no Cole memo implications, no state law violations
 - Identify subject and related parties
 - Addresses
 - Filing is solely because of marijuana-related business activities
 - No additional suspicious activity has been identified
 - Narrative section – “MARIJUANA LIMITED”
 - File continuing activity reports

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FinCEN-2014-G001

- Three new types of SARs (cont.):
 - Marijuana Priority – implicates Cole Memo or violates state law
 - All information required in Marijuana Limited filing
 - Details on the Cole memo priority implicated
 - Dates, amounts, and other relevant details of financial transactions
 - Narrative section – “MARIJUANA PRIORITY”

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FinCEN-2014-G001

- Three new types of SARs (cont.):
 - Marijuana Termination – If an institution deems it necessary to close an account of a marijuana-related business for compliance purposes
 - Include the basis for termination
 - Narrative section – “MARIJUANA TERMINATION”
 - If institution is aware that business is moving its account to another institution then terminating institution is “urged” to alert the other institution
 - Notwithstanding these new categories – must institution file a SAR naming its own employees and even itself?
 - The literal answer is yes...

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Lobbying FinCEN

- A strange dichotomy has emerged
 - OCC shares the industry concerns regarding continuing uncertainty (and liability) under the federal criminal laws
 - FinCEN — surprisingly — has indicated that FinCEN-2014-G001 was intended to authorize (and encourage) banks to open accounts for lawful marijuana entities

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Federal Banking Laws Implicated

- 12 USC §1818 (C&D; Removal, Prohibition, Suspension; CMPs; Termination of Insurance)
- 12 USC §1831o (Prompt Corrective Action; Reclassification - Unsafe & Unsound Practice)
- 12 USC §1831p-1
- Section 951 of FIRREA – 18 USC §1833a (DOJ CMPs)

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Responses at the State and Federal Level

- Bills in Congress to remove Marijuana as a Schedule 1 Drug
 - Soundly defeated for foreseeable future
- Senate Bill 1726 introduced in July to create protections for depository institutions providing financial services to MRBs
- At her confirmation hearing, Attorney General Lynch stated clearly she was against the decriminalization of marijuana
- Governor Christie stated that as President he would aggressively prosecute marijuana businesses under federal law

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Responses at the State and Federal Level

- New federal ethics rule precludes Colorado attorneys practicing in U.S. District Court from assisting clients in complying with state marijuana laws
- Minnesota Ethics Opinion No. 23 —
 - Minnesota attorneys can advise clients about complying with Minnesota medical marijuana law provided federal law risk is emphasized
- Nebraska and Oklahoma sued Colorado for legalizing marijuana
- Opponents of marijuana have used Civil RICO to force business participants to cut business ties

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Banking Marijuana—Legal Concerns

- Marijuana as collateral for a loan
 - Seizure rules under the CSA
 - Loan performance and collateral repossession
- Indirect dealings with MRBs
 - Due diligence issues
 - Preventative account and loan documentation
 - Aiding and abetting liability
- Fulfilling SAR responsibilities
 - Enhanced due diligence
 - Special SAR filings

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Banking Marijuana—Legal Concerns

- Officer and director liability and insurance coverage
- Examination issues
- Reputational risks
- Public safety risks
- Criminal liability under CSA

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QUESTIONS?

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