



The Future of California's Regulated Commercial Cannabis Industry

Regulatory Considerations, October 2016

Distribution & Transportation Committee

In June 2016, California Growers Association formed a Distribution and Transportation Committee (the “Committee”) for the purpose of working with regulatory agencies towards the common goal of effective implementation of commercial cannabis legislation. The Committee represents a diverse and comprehensive group of commercial cannabis distributors and transporters, and promotes a set of values and standards that protect industry, environment, and the community at large. Its members include a diversity of business models including agricultural cooperatives, independent distributors, online wholesale marketplace platforms, aggregation and processing centers, transportation and security providers, and ancillary business operators serving and supporting transporter and distributor businesses.

The Committee recognizes that the Distributor (Type 11) will play a critical role in regulatory implementation as a partner to both commercial cannabis operators and regulatory agencies. Our vision is a well-regulated marketplace that ensures economic viability for small business, supply chain integrity, and consumer safety.

To properly serve the California cannabis industry, many numbers of distributors will be required: small and large, regional and statewide, each offering various levels of service. We support the Bureau of Medical Cannabis Regulation (the “Bureau”) adopting the policy of issuing an unlimited number of state distributor licenses, and actively are working to encourage local governments to provide opportunities for local distribution facility permits, which local regulation is a linchpin of successful implementation of MCRSA.

In accordance with state-mandated requirements for Distributors to hold a Transporter (Type 12) license, the Committee addresses regulations and best practices for both distribution and transportation of commercial cannabis. Transportation regulations and best practices suggested by the Committee may be reasonably applied to other non-Distributor holders of Type 12 licensees

This document provides a discussion of the Committee’s proposed distribution and transportation-related regulatory considerations for state and local regulatory agencies.

Policy Distinctions
MCRSA vs. AUMA

Regulated Medical versus Regulated Adult Use

Licensing and regulation under the Medical Cannabis Regulation and Safety Act (MCRSA) of 2015 differ from the Adult Use of Marijuana Initiative (AUMA) on the ballot in 2016. At a high level, the primary differences between MCRSA and AUMA related to how product is transported and distributed follow:

MCRSA

- Third-Party Distribution
- Vertical Integration Limited
- Separate Transportation License

AUMA

- Self-Distribution
- Vertical Integration Allowed
- All Operators May Transport

Whereas MCRSA creates market segmentation by limiting cross-licensure across the respective categories of activity (production, distribution, retail), AUMA seeks to broaden the allowable cross-licensure activities for a single business, effectively eliminating most vertical integration restrictions. While some producers who currently sell to dispensaries prefer the flexibility of self-distribution and cross-licensure in AUMA, other producers prefer the protections against large-scale production and supply chain consolidation provided by MCRSA.

While the MCRSA-comparison-to-AUMA debate is ever prevalent and timely, the scope of this discussion is limited to the implications of *medical* cannabis regulations under MCRSA.

MCRSA Legislative Overview

Type 11 Distributors are those entities licensed to engage in the business of distributing medical cannabis or medical cannabis products received from licensed cultivators and manufacturers (Types 1-7) (“Producers”) to licensed Dispensaries (Type 10 and 10A). Type 11 licensees may operate in two ways: (1) by purchasing medical cannabis or medical cannabis products from a licensed producer and selling to a licensed dispensary; or (2) by executing sale contracts formed directly between producer and dispensary¹, in which case the Type 11 licensee is authorized to collect a fee for services rendered, including, but not limited to, costs incurred by a licensed testing facility, as well as applicable state or local taxes and fees.

In any case, Type 11 Distributors must perform a quality assurance function, ensure that a representative sample of each product batch is tested by the Type 8 Testing Laboratory, and track the flow of commercial cannabis products from producer to dispensary.

Type 11 Distributors are required to remain independent from other segments of the market. That is, a Type 11 Distributor licensee shall not hold a license in a

¹ Even under mandatory third-party distribution, MCRSA specifically allows cultivators, manufacturers, and dispensaries to directly contract with one another indicating the price and quantity of medical cannabis or medical cannabis products to be distributed.

cultivation, manufacturing, dispensing, or testing license category and shall not own, or have an ownership interest in, premises licensed in those categories other than a security interest, lien, or encumbrance on property that is used by a licensee. The only other license that a Type 11 can hold is the Type 12 Transporter license.

Each location where product is stored for the purposes of distribution must be individually licensed.

A distributor shall be bonded and insured at a minimum level established by the licensing authority.

***Type 11 and 12
Responsibilities and
Permissible Activities***

Distribution Business Models

Traditional Third-Party Distributor

A third-party facilitating wholesale transactions between buyers and sellers.

Traditionally, distributors are responsible for product procurement, storage and inventory management, sales, record keeping, fulfillment, payment collection, customer service, and often executing marketing contracts on behalf of their suppliers, or some combination of these activities. Distributors may have varying service offerings and strengths from one to the next, and therefore varying fee structures depending on the level of service provided. Unique to the cannabis industry, distributors are the only licensed operator that may conduct the product quality assurance verification required for the sale of product to dispensaries, a service that may be incorporated into a full-service offering or provided as a stand-alone service to producers. Distributor showrooms may be considered for business-to-business portfolio display, but with no consumer access or direct pick-ups.

Online Wholesale Marketplace Platform

An online-only wholesale marketplace that facilitates transactions between buyers and sellers.

Should the platform provider also decide to conduct distribution and transportation activities, respective Type 11 and 12 licenses would be required. However, it is unclear if marketplace technologies that facilitate transactions but do not touch the product would be required to obtain these licenses. For example, if a platform charges a fee for transactions between buyers and sellers and integrates with a state-mandated track-and-trace system, but does not take possession nor hold responsibility for the quality assurance verification of the underlying product, under what circumstances would a distributor license be required? Can a platform be unlicensed so long as it contracts with one or multiple licensed distribution operators for the quality assurance verification and track-and-trace requirements?

Agricultural Cooperative

An organization owned by its members who share resources for economies of scale.

Nonprofit Cooperative Associations [Food and Agriculture Code Section 54001 - 54294] are wholly owned by agricultural producers and provide efficiencies and services (such as branding, legal, and accounting services) to members and can act as either Supply Cooperatives or Marketing Cooperatives; the former provides supplies (such as seeds, fertilizers, nutrients, tools) whereas the latter undertakes activities relating to branding and distribution (such as packaging, transportation, and marketing). Agricultural Production Cooperatives pool resources (such as land and equipment).

MCRSA's cross-licensure restrictions may prohibit an agricultural cooperative owned by its (Cultivator-licensee) members from obtaining a distribution license unless MCRSA's definition of a "Owner" is re-defined². For example, if "owner" were rather defined as any person or entity holding a financial interest of five percent (5%) or more, a cooperative with 21 members or more (each owning less than 5%) could qualify for a distribution license. This model also requires legislative or regulatory clarity about who qualifies as an "owner" of a cooperative, and who would be held responsible as the cooperative "owner" if all members hold less than five percent.

Aggregation and/or Processing Center

Aggregates product from multiple producers; may centralize functions such as trimming, processing, and packaging.

The BMCR has suggested that product aggregation and packaging are allowable activities for distributors. The term "processing" has created confusion for operators and regulators, and requires further clarity. Processing may include activities that are not restricted to one license type, but rather allowable by both Producers and Distributors. For example:

- Cultivator *Processing* may include: trimming, curing, drying, and other post-harvest processes as defined in the Agriculture Labor Relations Act
- Distributor *Processing* may include: some combination of the above as well as packaging and repackaging of bulk product into retail-ready product
- Manufacturer *Processing* may include: some combination of the above, as well as chemical processing, extraction, infusion, filling, co-packing, and related activities (i.e. Blue Diamond Farming Co. Agriculture and Bulk Processing)

To the extent that the aggregation center or processor acts in the capacity of a clearing house that is conducting state-mandated quality assurance protocols, Type 11 and Type 12 licenses would be required. Otherwise, the aggregation center or processor would require a Cultivation or Manufacturing license.

² Currently, MCRSA includes in the definition of "Applicant," as a person with "any financial interest" in the business. (Bus. & Prof. Code Section 19300.5.)
Regulatory Considerations, October 2016, California Growers Association Distribution & Transportation Committee

Quality Assurance-Only Service Provider

An independent third party that verifies product quality, as required by law.

At its most fundamental level, the mandated function of the Distributor is to ensure the identity and quantity of the product and ensure a random sample of the product is tested by a licensed testing laboratory prior to retail distribution. The Quality Assurance and Quality Control section below outlines the state-mandated requirements in more detail. A basic distribution business model could include only serving in the quality assurance and testing verification role, and in no other capacity.

Transportation Only Service Provider

An independent Transporter that does not hold a license of any other type.

While Type 11 licensees must have a Type 12 license, and Types 1-7 licensees may hold a Type 12 license, other operators may choose to only hold a Type 12 license. A Type 12 licensee shall be bonded and insured at a minimum level established by the licensing authority. When a scheduled transport can not be completed in a single day, it is unclear whether independent Transporters will be required to park vehicles at their own licensed facilities, or if vehicles of licensed Transporters may be parked overnight at another licensee's location on the scheduled route. It is also unclear if an independent Transporter may be contracted by a Producer (or only by a Distributor) to do the fulfillment from the distribution facility to dispensaries, once the Distributor's QA verification is complete.

Non-Licensed Broker

A person or entity that connects buyers and sellers, negotiates terms, and facilitates transactions on paper, but does not facilitate the transaction physically.

If acting in this capacity and without taking possession of the product, should a broker be registered as an agent of a Type 11 Distributor in order to be paid for facilitating commercial cannabis transactions? Should regulators create a broker-only license? What restrictions should apply to allow someone in this role to possess product samples for the purpose of showcasing to prospective buyers, but not to distribute any such as samples?

Self-Distributing Producer

A producer (cultivator or manufacturer) that distributes its own products.

Although this business model is not expressly authorized under MCRSA, it is currently the most common example of how products are distributed currently. Many producers would like the ability to continue to self-distribute their products, or in other words to conduct the functions of the Distributor license type. It is generally understood that this would require legislative change, however existing producers would like clarity from regulating agencies as to how best to accomplish self-distribution, mainly for quality assurance and transportation.

*Contracts between
Licensees*

Contractual versus Regulatory Obligations

This section addresses some of the responsibilities of the Type 11 Distributor that can be defined by contract as opposed to being prescribed in regulation.

Producer-Dispensary Contracts

The MCRSA allows Producers to directly enter into contracts with Dispensaries indicating the price and quantity of medical cannabis or medical cannabis products to be distributed. In this scenario, the Producer contracts with the Type 11 Distributor primarily for the purpose of conducting the MCRSA-mandated third-party quality assurance verification and potentially for storage and fulfillment in exchange for a negotiated contract fee. However, the producer remains responsible for generating its own leads, negotiating prices with its Dispensaries buyers, and managing its own account sales orders and customer service.

Producer-Distributor Contracts

For Producers that contract directly with Dispensaries, or for Type 10A licensees that produce for their own dispensaries, they may have a limited scope contract with a Distributor partner, as described above and in the “QA-Only” Business Model section.

For Producers that do not contract directly with Dispensaries, they may seek a more full-service distribution partner as described in the Traditional Distributor section above. A few suggested terms to describe in distribution contracts may include:

- Term of Agreement
- Territory Exclusivity
- Distributor Duties
- Producer Duties
- Distributor Purchase Price
- Dispensary Wholesale Price
- Suggested Retail Price
- Collection / Payment Terms
- Performance Expectations
- Termination Clauses
- Product Liability
- Return Policy
- Insurance Requirements
- Reporting Requirements

Producers should dictate to Distributors in writing the proper storage protocols to ensure the quality of the products. State-mandated storage requirements can be troublesome if regulations prescribe certain protocols that conflict with the Producers’ own quality control protocols. To the extent that Distributors can prove they have upheld the quality control protocols set by the Producer (or regulatory body), they should avoid liability for quality degradation of the product in their custody.

Distributor-Dispensary Contracts

With regard to the Distributor-Dispensary relationship, it is possible that invoices may supplant the need for a contract, as is customary in other industries. The invoice would outline the quantity and price of the product purchased and the payment terms for which it is due, if not upon receipt. Additionally, the parties may agree to document the return or exchange policy. In other contexts, the parties may

desire a contract when dealing a set amount of a certain product at pre-negotiated prices, for example, from a particular producer with limited inventory.

Distributor-Distributor Contracts

For a healthy and efficient market, Distributors should be able to buy from and sell to other licensed distributors just as licensed cultivators may sell to licensed manufacturers, so long as the selling Distributor's contract with the producer does not restrict the underlying product from being resold.

Distributors may want to share warehouse space and fulfillment centers strategically located along key transportation corridors throughout the state, wherein multiple Type 11 licenses would register at the same address. Under this scenario, and if permitted by state and local regulations, landlords would provide leases to multiple businesses on one parcel or authorize the primary leaseholder to sub-lease to other Type 11 licensees.

Leases, Sub-Leases, and Shared Parcels

The BMCR, in pre-regulatory meetings, proposed that a landlord be defined as an "owner" only if it receives 40% or more of the proceeds of the licensed business.

Questions requiring further clarity:

- Would the ownership definition above allow for non-owner landlords (those who are not owners of the license) to lease to multiple licensees across all tiers without violating cross-licensure restrictions?
- If so, are leases required to be for separate parcels and/or buildings or can a single parcel and/or building be leased to multiple licensees, if the space utilized by each licensee is clearly defined?
- If parcels and/or buildings may be shared by licensees across multiple tiers, may a distributor have a licensed space on-site at a production facility if the distribution space is secured and exclusively accessible to the distributor?
- Similarly, may a testing laboratory be licensed on-site at a distribution facility under the same parameters?

Cost of Distribution

Businesses will determine the value of their services based on market conditions and depending on the level of service provided; from sourcing, procurement, quality assurance, testing, sales, packaging, marketing, branding, storage, fulfillment, payment processing, cash handling, quality assurance, and other value-added services that may be offered by a distributor. The cost of each service would be set by contract and determined by mutual agreement of the parties.

Credit Law

Credit Law in other industries (mainly Alcohol) applies to the terms under which product is sold from a wholesaler to a retailer. If a retailer becomes delinquent, the wholesaler must report this to the regulating agency. The agency compiles and publishes the Credit Law Delinquent List twice a month, listing all retailers who

are delinquent. While a retailer is delinquent, no sales or deliveries may be made to that retailer on or after the effective date of the list, even if the order was taken prior to the effective date. The retailer's buying privileges may resume only when all delinquencies are paid and the agency's records are cleared. No wholesaler is required to sell on credit to a retailer. However, if a wholesaler does extend credit, the wholesaler may do so only in accordance the law. For example, for purchases made from the 1st through the 15th day of a month, payment must be made on or before the 25th of that month; for purchases made from the 16th through the last day of a month, payment must be made on or before the 10th day of the following month.

***Distributor QA-QC
Responsibilities***

Quality Assurance & Quality Control

State-mandated quality assurance requirements

The MCRSA requires that “upon receipt of medical cannabis or medical cannabis products from a cultivator or manufacturer, a distributor shall first inspect the product to ensure the identity and quantity of the product and ensure a random sample of the medical cannabis or medical cannabis product is tested by a licensed testing laboratory [Type 8] prior to distributing the batch of medical cannabis or medical cannabis products to a dispensary.”

To ensure the *identity and quantity* of the product, the Distributor will rely on the results of the batch sample from the testing laboratory to confirm that the results of the individual unit tested matches the claims made on the product packaging. To the extent that individual units are pre-packaged into sealed boxes, the random sample selection for the testing laboratory will also be utilized by the distributor as the sample box spot-checked to verify that the packaging and labeling does not misrepresent the contents of box or individual units within.

To ensure a *random sample is tested by a licensed testing laboratory*, an agent of a testing laboratory shall obtain samples according to a statistically valid sampling method for each lot.

Random sampling by agent of the testing laboratory

The following factors should be considered to address supply chain efficiencies:

Consider accessibility and turn-around time.

- The testing laboratory shall obtain samples, and therefore should also be authorized to transport those samples. Ideally, the testing laboratory or it's agent should have a Transportation license, however, the MCRSA does not authorize a testing laboratory to hold any other license type under current statute.
- Aggregating sample selection at distribution facilities will help to centralize the sampling process. However, given the volume of product tested on a daily basis, testing laboratories will need full-time sampling agents available within a reasonable radius of each distribution facility. Otherwise,

serious bottlenecks will occur resulting in delayed “time-to-market.” This is an existing challenge faced by industry, with less than an estimated 5% of operators currently testing their products on a regular basis. Testing turnaround time is a major factor in supply chain efficiency.

Consider the costs of laboratory testing.

- State-mandated testing and resting is an expense of the producer, for both the test itself as well as the service of onsite random sampling and/or the fee to transport that sample to the laboratory.
- Batch size will significantly dictate the cost of laboratory testing.

Consider third-party checks and balances.

- Who will choose the testing lab? Will regulations dictate whether that the producer or distributor choose, or that it shall be determined by mutual consultation between both parties (recommended)?
- It may be decided that generic or anonymous “Sample IDs” be assigned to the samples when submitted to the laboratory for testing, to avoid special treatment that may compromise the results.

Consider the protocol when a product is deemed unfit for consumption.

- Regulators will determine the thresholds for failing lab results. These thresholds should be based on the best available science and should be debated among a diverse group of qualified stakeholders inside and outside the cannabis-testing field.
- Once thresholds are determined, a protocol must be established for appealing failed test results (to protect against false positives).
- Producers should be able to appeal an initial failed result through a defined protocol (for example, by having a second test occur with a secondary testing laboratory).
- When a second test is required, e.g. when the primary test result indicates the product is not fit for consumption (or otherwise resulting in a “failed” test result by state standards), it is advised that a secondary testing laboratory (and perhaps a separate agent) be used to validate or invalidate the initial result. Other regulated cannabis states have experienced instances of “lab switching” by producers when they receive unfavorable results from certain more rigorous testing laboratories versus those that are known to have a lower failure rate for product testing.
- When a sample fails, the batch must be allowed to be re-tested and/or the producer be allowed to attempt remediation before it is determined that product be destroyed. There are generally accepted remediation methods for removing most unwanted compounds (so that product would not have to be destroyed), however for residues of certain chemical pesticide there are not widely known methods.

- In the event that regulations require the destruction of product after opportunities to appeal have been exhausted, a representative of the state should be responsible for the destruction in the presence of the distributor and/or under video surveillance by the distributor according to the destruction method determined by the state. If product is to be destroyed, the destruction will be at the cost of the producer.
- Distributors should not be required to pay for product until the product has passed the quality assurance testing and verification. Similarly, insurance providers will not agree to insure product that does not pass the quality assurance testing and verification.

Packaging and labeling responsibilities

Regarding packaging and labeling, product may be packaged at the cultivator, manufacturer, or distributor level into the producers preferred branded packaging which shall have all the state-mandated requirements defined in law and regulations. If any state-mandated labeling is required to occur *after* the certificate of analysis is completed, it would be placed onto the packages by the distributor responsible for the quality assurance verification. However, it is recommended that the certificate of analysis be made available by the dispensary for consumers, but not required to be printed or stickered onto each individual product.

Quality control procedures for distributors

Distributors should be required by contract to uphold the quality control protocols for storage and transit outlined by each producer. Producers who feel their product degraded in quality due to improper care while in the custody of the contracted distributor may be entitled to seek remediation through insurance claims or arbitration with the distributor as defined by contract, not by regulation.

Regulations can assist to preserve quality control best practices through regulations that allow distributors to properly care for product. There have been concerns that distributors may not be able to open up producer product (primarily flower – dried and cured cannabis) while in its custody. The dried and cured cannabis is very sensitive to temperature and humidity, and therefore if those conditions unexpectedly change it is important to quickly react to bring the product back to the state in which its quality is best preserved. Sometimes this requires opening the product packaging to allow it to oxidize for a set period of time, and then resealing it. Perhaps distributors can have a tamper-evident sticker to seal on the product package prior to sale to dispensaries.

Quality Assurance and Verification for Nursery Products

Regulatory clarity is needed as to the quality assurance standards and requirements for Nursery (Type 4) Licenses, as well as if Nursery products (mainly clones) will be subject to third-party distribution requirements when distributed to dispensaries, while remaining self-distributed to Cultivators.

*Liability of Producers
vs. Distributors*

Ownership and Liability

Liability of producers versus distributors

Whether owned by or in the custody of the distributor, product in the care of the distributor is the liability of the distributor (and therefore its insurance provider):

- When damage, internal theft, or robbery of product or cash occurs while in the distributor's custody, whether in storage or in transit; with the exception of law enforcement seizure for which the distributor is not liable

Producer liability extends to:

- Any expenses of losses due to seized product and/or legal proceedings in the event the event of law enforcement seizure
- Any expenses or losses due to the product failing quality assurance testing, including expenses related to sending product out for remediation or, worst case, destruction
- Any expenses or losses due product quality degradation for reasons outside of distributor's control while product has been properly cared for in the distributor's custody
- Any product liability resulting from the contents or manufacture of the product, including any defects that cause or can cause harm to any persons
- Any uncollected monies from dispensaries which have entered into contract directly with the producer but failed to pay for product on the terms extended to dispensary by the producer

*Supply Chain
Integrity*

Transportation and Traceability

This section addresses transportation and traceability at a high-level but does not provide detailed regulatory recommendations.

Transportation Manifest

As product changes hands from one licensed operator to the next, electronic shipping manifests will be required to be completed prior to the transportation taking place. The BMCR has proposed a set of information to be included on the manifest that identify the sending and receiving parties, the contents of the load, the route, and the estimated departure and arrival times.

To what extent will this information electronically submitted need to be updated in real-time if certain particulars change, for example delays on the road or unexpected route changes? Learning from other regulated cannabis markets where restrictive regulations have caused severe bottlenecks and challenges for operators and law enforcement, the following flexibilities should be incorporated:

- Allow for transfer to another vehicle in cases when the original vehicle breaks down or is in an accident

- Allow for multi-day manifests, or in other words, do not require a transportation to have to occur in a single day, given the vast distances to be traveled in the state
 - Consider safety hubs every 100 miles or shared warehouses that can be used as a safe storage for vehicles overnight
- Allow for rejections of product (by the dispensary, for example) which would require a real-time update to the electronic manifest to return product to its place of origin

Transportation Vehicles

The Bureau has proposed the following list of vehicle types that may be used in transport as well as a list of minimum vehicle security requirements. Vehicle types may include vans, pick-up trucks and camper shells, open trailers and closed trailers, and other commercial vehicles. Transportation is limited to ground (not motor) vehicles, prohibiting aircraft, watercraft, drones, rail, and human-powered vehicles (such as motorized bicycles). Transport vehicles must have refrigeration, locking system, alarm system, and separation between drivers/passengers and product. Vehicle types should avoid freight terminal requirements, more akin to courier service vehicles.

Licensed Transporters

Transportation of any commercial cannabis products is limited to persons or entities holding a Type 12 Transporter license. Only Cultivators, Manufacturers, and Distributors may hold Type 12 licenses, with Cultivators and Manufacturers limited to transportation on the producer side of the supply chain (as modified in SB 837 Section 19328 Sub-Section (a)).

Will the individual employees or contractors of the licensed Transporter be required to be registered in a master database accessible to law enforcement? Will the agency issue specific identification to licensed transport drivers? The Bureau suggests that background checks for employees and contractors will not be mandated by state and should be the responsibility of the business.

The Bureau has proposed potential quantity thresholds, under which, transport could occur without a license. How would such loads be tracked and traced through the system? Would unlicensed transporters be subject to the same vehicle and manifest requirements as licensed Transporters? Clarity is needed as to the thresholds and how unlicensed transport of commercial cannabis will be regulated.

Tracking Product Loss and Free Product

With certain products, primarily cannabis flower, loss is inevitable. Loss (or “shrinkage”) occurs due to changes in the moisture level of the flower as well as in the process of breaking down the materials into smaller units of measure or converting the cannabis flower into an oil or other concentrated form. For traceability purposes, regulators will need to determine how to allow for reasonable

amounts of product loss as the product moves through the supply chain, changing hands and in some cases changing forms.

Free product is easier to track, with a \$0 value for the sale or through discounts retroactively applied to products. A significant part of the sales process is the offering of free product to dispensaries. Free products are typically provided to the dispensary buyer to evaluate the product in consideration of a future purchase. These free products should be indicated in the traceability system as products “not-for-resale” and therefore not placed into inventory as these products will never be sold to an end consumer. However, other free samples may be provided to patients of the dispensary for giveaways as well as compassion programs for seriously ill patients. These free samples should be recognized as dispensary inventory but able to allocated as a free product with a non-taxable \$0 transaction value. Lastly, other free product may be provided to the dispensary for the purpose of showcasing the product in an open container. For example, if pre-packaged tamper-evident seals cannot be broken, patients still need to opportunity to see and smell the product (primarily for cannabis flower) before making a purchase decision. The producer or distributor should be able to provide an amount of product “not-for-resale” that is for the purpose of showcasing in the dispensary. When this product is no longer usable for showcase purposes, it may be given away for free through a non-taxable \$0 transaction to patients of the dispensary, or if it has been touched or tampered with it may need to be disposed of instead.

*Tax Reporting
and Collection*

Revenue Reporting and Taxes

Distributors play a critical role in the protecting against diversion and in the reconciliation of product moving through the supply chain. Regulators may audit distributors in order to reconcile distributor purchase records with producer sales records, and similarly to reconcile distributor sales records with dispensary purchase records. Records between buyers and sellers must match exactly or the entities involved will be subject to investigation.

State records will indicate the taxable income for the operators that are subject to federal and state taxes, and in some cases local taxes as well. Should the state decide to impose an excise tax (as was proposed in 2016 legislation) the excise tax may be collected at the point of distribution. This centralized tax collection would expedite payments to the state and reduce the burden for state agencies to collect from several thousand individual producers or dispensaries.

Access to Distribution

Distribution Pathways for Small Businesses

Cottage cultivators and small manufacturers have expressed concerns about the access to and costs of distribution. It will be imperative to license many distributors throughout the state, allowing for localized regions to have access to distributors. Similarly, testing laboratories will need to have many sites where sample collection takes place regularly in those same regions.

These small business operators are ultimately seeking alternative access points for getting their product to market, such as certified growers markets, onsite sales from the cultivation site (such as with bed-and-breakfasts, or similar to the winery and brewery model), and special event permits (including private event programs) allowing for tradeshows and farm-to-table type experiences. Under each of these scenarios, a distributor would still be utilized for the quality assurance verification of all products being distributed.

The biggest factor contributing to accessibility of distribution is local permitting. Local cities and counties may not be moving fast enough to develop ordinances and issue local approval for all commercial cannabis business types. Come 2018, there may not be enough locally permitted businesses to qualify for state licensure. As much as state agencies can do in the way of educating local governments and encourage them to develop ordinances, the better positioned the industry will be for a fair and equitable opportunity to bring existing businesses into compliance.

Transition Timeline

Smooth Transition for Existing Businesses

Industry operators working towards becoming compliant have questions about how they safely begin transitioning and positioning for the future while continuing to operate under pre-MCRSA laws. Similarly, there are many questions about what the affirmative defense will be for traditional medical patients associating collectively one year after the first license is issued, where as AB 266 reads (and hereafter referred to as the “Transition Deadline”):

Section 11362.775 of the Health and Safety Code is amended to read:

11362.775. (a) Subject to subdivision (b), qualified patients, persons with valid identification cards, and the designated primary caregivers of qualified patients and persons with identification cards, who associate within the State of California in order collectively or cooperatively to cultivate cannabis for medical purposes, shall not solely on the basis of that fact be subject to state criminal sanctions under Section 11357, 11358, 11359, 11360, 11366, 11366.5, or 11570.

(b) This section shall remain in effect only until one year after the Bureau of Medical Marijuana Regulation posts a notice on its Internet Web site that the licensing authorities have commenced issuing licenses pursuant to the Medical Marijuana Regulation and Safety Act (Chapter 3.5 (commencing with Section 19300) of Division 8 of the Business and Professions Code), and is repealed upon issuance of licenses.

Existing operators who are eager to transition into the newly regulated market share a major concern regarding how they will continue operating with existing upstream producers and downstream dispensaries who have not yet received a state license. For example, the first state licensed business would experience extreme financial hardship if not allowed to continue collectively sourcing from and providing to its existing patients immediately upon receiving its state license.

To smooth the transition, state-licensed operators should be able to continue conducting their regular business activities *until the Transition Deadline*, so long as the operators they are working with have 1) a local permit or authorization as well as 2) an “application in-process” or “pre-registration status” with the state licensing agency.

Successful implementation will require state-licensed operators to continue conducting business with their existing upstream and downstream operators during the first 12 months of the licensing transition, for the following reasons:

- Existing businesses will suffer by being the early “**Approved**” licensees because their existing vendors and customers will not yet be Approved, thereby dis-incentivizing early application submissions.
- Requiring applications to be “**In Process**” (applications submitted that are awaiting approval) is equally challenging before the Transition Deadline, given that operators may not be prepared to submit applications at the same time as the operators they work with upstream or downstream.
- Instead, licensing agencies may consider a Pre-Registration process that requires applicants to be registered with the licensing agency and to provide an estimated date of their application submission. This would allow for the identification of “**Pre-Registered**” operators that are qualified for Approved licensees to continue doing business with *up until the Transition Deadline*. It would also provide licensing agencies with application submission estimates for proper staffing and planning.
 - A unique identifier to each applicant or pre-registrant can be used by licensed operators to verify the status of operators that qualify
 - Pre-Registrants may be required to participate in the Track & Trace Program while working with operators Approved and In-Process

Licensing agencies should consider that an operator’s local authorization may be issued to a collective, cooperative, not-for-profit mutual benefit corporation (MBC), or other entity, whereas the entity applying for the state license may be the same or may be an affiliated for-profit entity in some instances, whereby having a different name than the locally-authorized entity. In addition, regulatory clarity is required to define an “Owner” for collectives, cooperatives, and MBCs that are governed by a Board of Directors or Executive Management Committee.

Moving Forward

Working Together

The considerations presented here open up many more questions. However, they are a good starting place to understanding how distributors will interact with upstream producers, downstream dispensaries, horizontal testing laboratories, and regulatory agencies. The committee will continue to explore these questions throughout the regulatory drafting process and we look forward to working together with stakeholders towards a well-regulated future.