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PRIVILEGED & CONFIDENTIAL

Date: November 18, 2017

To: Lawyers Committee for Civil Rights of the San Francisco Bay Area

From: Davis Polk & Wardwell LLP

Re: **Bank Regulatory Considerations Related to Establishing a Public Bank in the State of California**

You have asked us about the City of San Francisco's ability to establish a public bank. This memorandum directly addresses that question by discussing select provisions of California and U.S. federal bank regulatory law that would apply to a public bank, the shares of which would be wholly owned by a municipality. It also considers the California and U.S. federal bank regulatory law that would apply to a public bank owned by the State of California.¹

We understand that there is a desire to establish a public bank in California that could provide greater access to banking services to underbanked populations such as those with lower income and local small businesses. We also understand that there is a concern about the lack of banking services and related access to the payment systems for businesses directly engaged in activities involving cannabis that are legal under state law.² As provided in the recent report by the Cannabis Banking Working Group established by

¹ This memorandum addresses only California and federal bank regulatory law and does not consider any other federal or state laws. For example, we are providing no tax advice in this memorandum. This memorandum also does not address the question of whether a public bank could be established by a regional joint powers authority under California law. We note this question as a topic for further exploration.

² Under California law, medical cannabis is currently legal and the sale and taxation of cannabis for recreational purposes will go into effect on January 1, 2018. References in this memorandum to cannabis businesses assume a state legal business that is otherwise compliant with applicable laws and regulations, including tax regulations, except for the federal laws under the Controlled Substances Act and other similar laws that criminalize cannabis at the federal level.

California State Treasurer John Chiang, *Banking Access Strategies for Cannabis-Related Businesses* (the “**Chiang Report**”), the combined impact of the lack of banking services for the cannabis sector and the increase in sales of cannabis for recreational purposes anticipated upon the effective date of the new law presents public safety concerns. In the Chiang Report, the Cannabis Banking Working Group makes four recommendations to address what it refers to as the “cannabis banking problem”: (1) the implementation of safer, more effective, and scalable ways to handle the payment of taxes and fees in cash that minimize the risks to stakeholders; (2) the development of a data portal of compliance and regulatory data to be made available to financial institutions that bank cannabis businesses; (3) a feasibility study of a public bank or other state-backed financial institution that provides banking services to the cannabis industry; and (4) a multistate consortium of state government representatives and other stakeholders should be established to pursue changes to federal law to remove the barriers to cannabis banking.³

With respect to the recommendation for a feasibility study of a public bank, the report suggests that the study consider “costs, benefits, risks, and regulatory issues, including capitalization, deposit insurance, and access to interbank funds and transfer systems,” as well as “various ownership structures, including appropriate mixes of public and private capital” and “a legal analysis addressing the legality and associated legal risks of creating a public cannabis financial institution, including, but not limited to, whether such an institution can be created without violating federal law, the extent to which it would remain subject to federal oversight and regulation, and whether tax revenues deposited in it could be at risk of seizure by the federal government.”⁴ Much of the analysis in this memorandum is a deeper dive on some of these technical legal issues foreshadowed in the Chiang Report.

In this memorandum, we first provide a general background of public banking in the United States and then review some of the issues affecting the ability of state legal cannabis businesses to obtain banking services. We analyze the questions listed below with respect to each of two distinct business models: the “**Traditional Public Bank Business Model**,” which refers to a public bank that does not offer banking services to cannabis businesses, and the “**Traditional Plus Cannabis Business Model**,” under which a public bank would provide banking services to state legal cannabis businesses as part of its initial business plan.⁵

Subject to the facts and assumptions set out in this memorandum, we examine a series of questions related to the establishment of a public bank and provide a brief summary answer for each. We expand upon these answers in the sections which follow.

³ State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 2 (2017).

⁴ *Id.* at 4.

⁵ It is not anticipated that the public bank would be a monoline bank providing services only to the cannabis sector. As the Chiang Report notes, regulators tend to disapprove of financial institutions that are overly concentrated in one industry, because the fortunes of those institutions are too closely tied to the industries they serve, and so would be in danger of failing if the industries they serve experienced a downturn. See State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 4 (2017).

1. What bank or bank-like charters are available under California law for a public bank?

We have examined three potential charters for a public bank. The first is a “**Public Bank Charter**,” a charter established by special statutory authority for or on behalf of a public entity. The second is a “**Commercial Bank Charter**,” a charter for one of the traditional depository institutions such as a commercial bank, savings and loan or industrial bank that exist under California state law and that is designed for private sector investors. The third, a “**Credit Union Charter**,” is a charter for either a federally-insured or privately-insured credit union.

There is currently no option under California law for a Public Bank Charter, although a properly crafted statute would be ideal for a public bank. As a threshold matter, based upon instructions from you, we have assumed the conclusions in the 2013 memorandum from the San Francisco city attorney to Supervisor Avalos (the “**Owen Memo**”): (1) that neither the provision of the Government Code prohibiting a county from giving or loaning its credit to any person or corporation nor the provision of the California Constitution limiting the power of the state legislature to give or lend the credit of cities or counties would bar the City of San Francisco from establishing a public bank; and (2) that the City of San Francisco would have the power to own the shares of a public bank under California law, despite the state constitutional restrictions on owning corporate stock, if the City appropriated funds for that purpose and the operation of the bank served a legitimate municipal purpose. Based on the analysis in the Owen Memo, we further assume that ownership of a public bank providing greater access to banking services to underbanked populations in the City of San Francisco would be considered a legitimate municipal purpose.⁶

There are substantial drawbacks to both the Commercial Bank Charter and the Credit Union Charter that would be challenging in the public bank context. Both the Commercial Bank Charter and the Credit Union Charter would require the approval of the California Department of Business Oversight, a sound business plan, experienced management and appropriate capitalization.⁷ The

⁶ See Mem. from Thomas J. Owen, Deputy City Att’y, to John Avalos, Member, Board of Supervisors, Municipal Bank Formation (May 15, 2013). We take note of the memorandum prepared by the legal counsel of the Financial Institutions Division of the New Mexico and Licensing Department (the “**New Mexico FID Memo**”), which argues that the establishment of a public bank in New Mexico would be a direct violation of the terms of the “anti-donation clause” of the New Mexico constitution. As we understand it, as applied to a public bank, the so-called anti-donation clause generally prohibits a state, county or municipality from lending credit to any private person or corporation. Based on the Owen Memo, however, we assume that a public bank in San Francisco would not be subject to the constitutional limitations that have been raised as an issue by the New Mexico FID Memo. See Mem. from the New Mexico Regulation and Licensing Department, Financial Institutions Division, Legal Issues and Matters for Further Research and Examination Regarding Proposed Public Bank of Santa Fe (Aug. 24, 2017), https://www.santafenm.gov/media/archive_center/Item_3.pdf#page=128, at 8.

⁷ Credit unions do not issue stock as would a commercial bank; their start-up capital generally comes from donations and grants. Their capital is generally generated through retained earnings. Part of the evaluation of a charter would involve consideration of the ability to generate sufficient capital through earnings and other sources.

use of the Commercial Bank Charter and the Credit Union Charter under California law would in many ways be like putting a square peg in a round hole—forcing the public shareholders of the proposed public bank to retrofit the public bank business model into a regulatory system that was designed for private sector investors.

The use of a Credit Union Charter is a bit more of a possibility, although challenges exist. As credit unions do not have shares, it is somewhat inconsistent to think of a credit union being a public bank, at least in the way defined above. However, it is conceivable that the City of San Francisco could sponsor a credit union and provide the seed funding for its organization and operation or that the City of San Francisco could be the member of a state-chartered credit union.⁸ Under California law, a credit union may have either federal or private insurance. The feasibility of retrofitting the Credit Union Charter requires that private insurance acceptable to the commissioner of the California Department of Business Oversight be available and that the California Department of Business Oversight would not, as is typically the case, insist upon at least 500 members.

The obstacles with respect to each of a Commercial Bank Charter and a Credit Union Charter have driven most advocates of public banks to assume the need for special statutory authority.

2. *What federal banking laws would affect the ability of such a public bank to operate?*

A public bank owned by the state or a political subdivision and using the Commercial Bank Charter would need to apply for federal deposit insurance, maintain the high capital levels that the FDIC requires for a *de novo* bank⁹ and keep to a preset business plan for at least three years. It would generally be subject to the full panoply of federal laws and regulations governing operations, safety and soundness, permissible activities and similar requirements. It is highly likely that the public sector investors would be required to serve as a source of strength to the bank. Laws that severely limit the ability of the bank to lend money to its controlling investors and to affiliates (*i.e.*, to other political subdivisions of the state of California) would most likely apply, although that is not certain. We believe that it would be a difficult challenge to get federal deposit insurance for a commercial bank using the Traditional Public Bank Business Model and, until federal law changes with respect to cannabis, impossible for a bank using the Traditional Plus Cannabis Business Model.

⁸ The City of San Francisco would not be permitted to be a member of a federally-chartered credit union; thus, were it to be deemed necessary for the City to be a member, a state-chartered credit union with private insurance would be the only realistic option.

⁹ The term “*de novo* bank” refers to a newly chartered bank. It is typically the case that a *de novo* bank is subject to stricter regulatory scrutiny in its start-up years, including higher than minimum capital and a requirement that there be a preset business plan.

A privately insured credit union would not be subject to the prudential oversight of any federal banking regulator.

3. *Would such a public bank be able to access the Federal Reserve's payments system, either directly or indirectly?*

A public bank that operates under a Commercial Bank Charter or Credit Union Charter and uses the Traditional Public Bank Business Model should, over time, be able to open a master account at the Federal Reserve Bank of San Francisco, although we believe that the Federal Reserve Board and the regional Federal Reserve Banks will continue to take the view that granting such a master account is discretionary.

Most *de novo* banks originally access the Federal Reserve payments system through a correspondent banking relationship. Despite the recent Tenth Circuit opinion in *Fourth Corner Credit Union v. Federal Reserve Bank of Kansas*,¹⁰ we do not think that the Federal Reserve Board or the Federal Reserve Bank of San Francisco would likely open an account for a public bank with the Traditional Plus Cannabis Business Model without either a change in federal law or a direct court order. A public bank operating under the Traditional Plus Cannabis Business Model might, over time, have access, via correspondent banking, to the Federal Reserve payments system, depending upon the policies of the Trump Administration with respect to prosecutorial discretion and the willingness of the correspondent bank to provide such services, although we expect that such access will remain challenging without changes to federal law.

4. *Is there a viable argument under the Tenth Amendment to the U.S. Constitution that the provision of banking services by a public bank to state legal cannabis businesses is protected and that federal law would not apply?*

No.

5. *What legislation at the state or federal level would provide clearer solutions?*

The most definitive action that could alleviate many of the concerns addressed above would be to decriminalize cannabis at the federal level and to bring the entire cannabis business sector into a fully legal and tightly regulated framework. A tailored California statute, loosely based on the Bank of North Dakota model, would provide a clear path to a public bank charter. Such a bank would likely need private or state funded insurance, and its access to the Federal Reserve payments system would be problematic.¹¹ Some of these concerns

¹⁰ *Fourth Corner Credit Union v. Fed. Reserve Bank of Kansas City*, No. 16-1016 (10th Cir. filed June 27, 2017).

¹¹ Even aside from banking services, it is clear that a legal cannabis business would need to be subject to significant regulation in other aspects as well. For a discussion of what a regulatory situation might look like, see

could be alleviated were cannabis to be decriminalized at the federal level. It is possible that if the Trump Administration were to continue the policy of prosecutorial discretion initiated by the Obama Administration, other banks and credit unions would be willing to offer correspondent banking arrangements to such a public bank. As noted in the Chiang Report, the policies of prosecutorial discretion provide a “narrow and fragile” path for banking services.¹² Passage of federal legislation, such as the Secure and Fair Enforcement Banking Act (the “**SAFE Act**”) or the Respect State Marijuana Laws Act of 2017, by Congress would be a major step forward. More detail on our proposed next steps, which primarily involve changes in legislation, is included at the end of this memorandum.

I. Background

We begin with a background section that examines the history of public banking in the United States, a review of recent advocacy around the public banking concept and a discussion about how we believe, based upon our review of media and other public sources, that private sector banks are engaging, or not engaging, with state legal cannabis businesses today.

a. The Bank of North Dakota

Advocates of public banking often assert that there is only one public bank in the United States, the Bank of North Dakota. That assertion would be more accurately stated as there is, at this time, only one successful public bank in the United States. The recently insolvent Government Development Bank for Puerto Rico is a cautionary tale of an unsuccessful public bank in the United States.¹³

The Bank of North Dakota, a bank with approximately \$7 billion assets,¹⁴ is the only state chartered public bank currently functioning in the United States. The size of the Bank

National Association Cannabis Businesses Guiding Document, https://nacb.com/harmony-obj-root/2017-10/NACB_Guiding_document.pdf (National Association Cannabis Business is the cannabis sector’s first self-regulatory organization).

¹² State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 3 (2017).

¹³ Another example of a public sector bank in the United States was the U.S. Postal Bank, which began operations in 1911 and closed in 1967. The U.S. Postal Bank was a narrow bank which took deposits from the public and invested only in U.S. Treasuries. There are, and have been, in many other countries around the world, state-owned public banks. It is safe to say that in most of Western Europe and Japan, state-owned banking has generally been in retreat in recent years. An important exception is Germany, which has an extensive system of municipal banks, known as Sparkassen, and regional banks controlled by state governments, known as Landesbanken, that make up an integral component of the German banking system. In our view, state-owned banks in China and most emerging nations are not a close model to the public banks under discussion in the United States.

¹⁴ Bank of North Dakota, *Quarterly Report: Balance Sheets Mar. 31, 2017*, at 1 (2017).

of North Dakota makes it a relatively small bank in the structure of the U.S. banking sector. For instance, if it were a private sector bank, it would be classified as a community bank.¹⁵

The Bank of North Dakota was chartered in 1919 pursuant to an explicit and special chartering authority contained in the North Dakota constitution that is implemented via a specific North Dakota state statutory authority. The Bank of North Dakota's mission is to "deliver quality, sound financial services that promote agriculture, commerce and industry in North Dakota."¹⁶ Like a private sector bank under California law, the Bank of North Dakota takes deposits and makes loans. In addition to taking deposits from state and government agencies, the Bank of North Dakota also offers basic checking and savings accounts to North Dakota residents. Because of its policy of not competing with the private sector for retail deposits, however, it does not provide various services such as ATM cards, debit cards, credit cards or online bill pay to the public.¹⁷ It has only one office.¹⁸

It does not operate like most banks and in many respects is similar to a bankers' bank.¹⁹ The Bank of North Dakota does not deal directly with borrowers for the business and agricultural loans that comprise about half of its loan portfolio but instead participates in loans that are originated by North Dakota community banks.²⁰ As a result, these loans are made under private sector credit underwriting standards. Moreover, as a result of its cooperation, rather than competition, with North Dakota community banks, the Bank of North Dakota enjoys the support of the private banking sector in North Dakota. The Bank of North Dakota does however interface directly with borrowers for student loans, which as of the end of 2016 accounted for approximately 29% of its total loan portfolio.²¹ These loans, which are a relatively recent addition to the loan portfolio, are guaranteed by the State of North Dakota.²² The Bank of North Dakota also works directly with borrowers to originate mortgages for primary residences in certain areas where private sector mortgage services are not readily available.²³

¹⁵ The report issued by the Treasury Department on June 12, 2017, A Financial System that Creates Economic Opportunities: Banks and Credit Unions, defines "community banks" as banks with less than \$10 billion in assets. Department of the Treasury, A Financial System that Creates Economic Opportunities: Banks and Credit Unions (June 2017), <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

¹⁶ Bank of North Dakota, *Mission, Vision, Core Values*, <https://bnd.nd.gov/mission/> (July 12, 2017).

¹⁷ Bank of North Dakota, *Public*, <https://bnd.nd.gov/public/> (Nov. 7, 2017).

¹⁸ The Federal Reserve Bank of Boston, *The Bank of North Dakota: A model for Massachusetts and other states?* 8 (2011).

¹⁹ A "bankers' bank" generally refers to a financial institution that provides financial services to community or regional banks in the United States. The goal of a bankers' bank is to provide community or regional banks (as well as their customers) with access to services that, due to pricing or other reasons, would generally only be available to larger banks, thereby enabling the community or regional banks to more effectively compete with larger banks.

²⁰ Institute for Local Self-Reliance, *Public Banks: Bank of North Dakota* (July 2, 2015), <https://ilsr.org/rule/bank-of-north-dakota-2/> (Aug. 8, 2017).

²¹ Bank of North Dakota, *Annual Report 2016*, at 17 (Dec. 31, 2016).

²² *Id.*

²³ Bank of North Dakota, *Mortgage Origination Program for rural lenders*, <https://bnd.nd.gov/home-loans/mortgage-origination-program-for-rural-lenders/#1444412166015-a96c91c4-68d4>.

Thus, although in many ways the Bank of North Dakota is similar to a bankers' bank, the analogy is imperfect. Unlike private sector banks, the Bank of North Dakota enjoys a dominant position with respect to the deposits of all North Dakota state funds because, under the North Dakota state constitution, "[all] state funds and funds of all state penal, educational and industrial institutions may be deposited in [the Bank of North Dakota]."²⁴ This authority gives the Bank of North Dakota a stable core deposit base from which to fund its loans. Another important differentiating factor enjoyed by the Bank of North Dakota is that all of its deposits are guaranteed by the state of North Dakota itself and not by the Federal Deposit Insurance Corporation (the "FDIC").²⁵

A critical element of the Bank of North Dakota business model is that it is run to make a profit.²⁶ The bank evaluates loan opportunities according to how likely they are to be repaid and provide a return; indeed, the model of participating in loans that have met the credit underwriting standards of local private sector banks is one means to ensure that loans will be made only if there is an expectation of repayment.²⁷ The bank's president and chief executive, Eric Hardmeyer, has commented:

If you are going to have a state-owned bank, you have to staff it with bankers. If you staff it with economic developers you are going to have a very short-lived, very expensive experiment. Economic developers have never seen a deal they didn't like. We deal with that every day.²⁸

b. The Government Development Bank of Puerto Rico

The counterexample to the Bank of North Dakota is the now insolvent Government Development Bank for Puerto Rico. The Government Development Bank was created in 1942 to finance Puerto Rico's infrastructure and was highly successful in its early years.²⁹ Unlike the Bank of North Dakota, over time, it was given tremendous powers and became the fiscal agent and financial advisor to the island and was intertwined with the daily functioning of the Puerto Rican government.³⁰ Like the Bank of North Dakota, the Government Development Bank for Puerto Rico benefited from the deposits of other Puerto Rican governmental entities, was created by a special statute and did not have federal deposit insurance. Unlike the Bank of North Dakota, the Government Development Bank for Puerto Rico was not run like a commercial bank. According to its then president and Chairwomen, Melba Acosta Febo, "The problems started when the Government Development Bank started lending for deficit financing instead of capital improvements . . .

²⁴ N.D. Cent. Code § 6-09-07 (1991).

²⁵ *Id.*

²⁶ Institute for Local Self-Reliance, *Public Banks: Bank of North Dakota* (July 2, 2015), <https://ilsr.org/rule/bank-of-north-dakota-2/>.

²⁷ *Id.*

²⁸ Rob Garver, *Reluctant Role Model*, 121 *Am. Banker*, (Apr. 4, 2011), at 24.

²⁹ Mary Williams Walsh and Michael Corkery, *Behind Puerto Rico's Woes, a Broadly Powerful Development Bank*, *The New York Times* (Nov. 29, 2015), <https://www.nytimes.com/2015/11/30/business/dealbook/behind-puerto-ricos-woes-a-broadly-powerful-development-bank.html>.

³⁰ *Id.*

and when it started lending to entities that didn't have a source of repayment."³¹ The Government Development Bank for Puerto Rico announced in 2017 that it would liquidate and wind down after becoming insolvent.³²

c. Public Bank Business Models under Discussion in the Public Bank Movement

In the aftermath of the financial crisis, there has been increasing interest in state- or municipal-level banks. Public banking advocacy groups in over 20 states, typically linked to progressive movements, are collaborating with city and state officials to promote public banking.³³ Our review of the literature reveals that many in the public bank movement, like citizens in general, do not have a solid understanding of how a bank operates. As a result, in this section, we set forth some basics about a bank balance sheet as well as discuss some of the business models that are discussed in the literature.

For any bank, public or private, to operate profitably and take advantage of the power of leverage, it needs a steady source of stable core deposits or other debt funding. It uses those deposits to fund projects which it can underwrite as loans (the asset side of its balance sheet). To provide a cushion for losses and to absorb other expenses, banks have some form of shareholder equity capital.³⁴ Banks operate under a fractional reserve model, which means that they need to maintain, in the form of cash or other highly liquid investments, only a small portion of the deposits they have received, even though most deposits legally can be withdrawn at any time. This permits banks to use the deposits and other borrowings to fund loans, the vast majority of which will have maturities longer than the deposits. This difference is known as maturity mismatch.

Prior to the adoption of federal deposit insurance, banks were often subject to runs and panics. Federal deposit insurance creates a stability in core deposits, even though they generally may be withdrawn on demand by the depositor, because they tend to act in predictable ways that can be modeled permitting the bank to treat such deposits as if they were long-term debt. State or municipal deposits, including tax receipts and the proceeds from state bond issuances awaiting reinvestment, could be a source of stable deposit funding for a public bank. Since stable core deposits are generally a cheaper source of funding than long-term debt, they are an attractive source of funding. The use of deposits from state entities has proven beneficial to the Bank of North Dakota. As its financial condition deteriorated, the Government Development Bank for Puerto Rico, like any bank in trouble, began to lose its deposit base.

We understand that one model of a public bank under discussion in California is to include both retail deposits and deposits from a municipal owner, although retail deposits

³¹ *Id.*

³² Eric Platt, *Puerto Rico's Government Development Bank strikes deal on debt burden*, The Financial Times (May 15, 2017), <https://www.ft.com/content/60f2e78f-0e24-3ec3-b89a-6e1533cd0505>.

³³ Public Banking Feasibility Study: Final Report for the City of Santa Fe, 6 (Jan. 2016), http://www.santafenm.gov/document_center/document/4520.

³⁴ See Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial Regulation: Law and Policy* 131-55 (Robert C. Clark et al. eds., 1st ed. 2016).

would raise the likelihood that some form of deposit insurance would be required by the California Department of Business Oversight. We note the concerns expressed in the New Mexico FID Memo that because of its heavy dependence upon deposits from one source, the City of Santa Fe, a sudden reduction in funding by the City of Santa Fe “could result in immediate jeopardy to the financial security of the bank.”³⁵ We understand that certain public bank models under discussion in California, including the proposal for a public bank owned by the State of California described in the Chiang Report, include the concept of both deposits from the municipal or state owner and from others, including the retail public, and so would differ from the model under discussion in Santa Fe.

For the asset side of the balance sheet, advocates propose that a public bank would fund projects that support economic development in its region, provide credit to underbanked low income citizens, make up the gap in lending to small- and medium-size enterprises and, in some instances, make loans to its public entity shareholders or other state governmental entities to replace, at least in part, the municipal bond issuances currently used by such entities.³⁶ In California, the concept of the public bank has, for many, begun to be melded with the need for local cannabis businesses operating permissibly under state law to have more access to banking services. The contrasting fortunes of the Bank of North Dakota and the Government Development Bank for Puerto Rico reveal the challenges that exist in loan underwriting decisions by any public bank.³⁷ The risk that a public bank might be incentivized or forced to make loans based on political preferences, rather than on the basis of prudent financial and economic considerations inherent in typical loan underwriting, should be mitigated through appropriate governance mechanisms and other safeguards.³⁸ The fact that the public bank model has worked well in North Dakota and not in Puerto Rico illustrates the critical importance of such governance mechanisms and safeguards.

Capitalization is a difficult issue for the public bank model. The public shareholders would be required to raise funds to capitalize the public bank at an acceptable level. The capital will be needed to fund operating expenses until the bank obtains profitability and to

³⁵ Mem. from the New Mexico Regulation and Licensing Department, Financial Institutions Division, Legal Issues and Matters for Further Research and Examination Regarding Proposed Public Bank of Santa Fe (Aug. 24, 2017), https://www.santafenm.gov/media/archive_center/Item_3.pdf#page=128. The concern that a bank might be overly dependent upon deposits from one or a weighted group of depositors has a historical precedent. Histories of the Banking Crisis of 1933, which started in the state of Michigan, recount how the banks controlled by Ford Motor Company were dependent on deposits from Henry Ford. Ford's actions around his deposits were an exacerbating factor in that crisis. See Susan E. Kennedy, *The Banking Crisis of 1933* (1973); see also Darwyn H. Lumley, *Breaking the Banks in Motor City: The Auto Industry, the 1933 Detroit Banking Crisis and the Start of the New Deal* (2009).

³⁶ See Public Banking Feasibility Study: Final Report for the City of Santa Fe, 7 (Jan. 2016).

³⁷ Similar issues have been faced by state-owned banks in other countries.

³⁸ The concern about politically driven credit decisions has also been raised by the legal counsel for the Financial Institutions Division of the New Mexico Regulation and Licensing Department. The New Mexico FID Memo states that “[w]hen the government owns the banks, lending decisions could become increasingly driven by politics, rather than economics. Resources flow to those with influence. Government-owned banks may also tend to under-price risk in order to gain votes. If there is one lesson we should take away from the recent crisis, it is that when you under-price risk, bad things happen.” Mem. from the New Mexico Regulation and Licensing Department, Financial Institutions Division, Legal Issues and Matters for Further Research and Examination Regarding Proposed Public Bank of Santa Fe (Aug. 24, 2017), https://www.santafenm.gov/media/archive_center/Item_3.pdf#page=128, at 8.

absorb losses from loans that are not repaid.³⁹ The amount of capital necessary would depend on the anticipated size of the balance sheet and business plan of the public bank. A report by the Federal Reserve Bank of Boston that examined whether the Bank of North Dakota model could be implemented in Massachusetts noted that the Bank of North Dakota was capitalized initially through a \$2 million bond issue in 1919 which, adjusted for inflation and for the growth of the economy, would be the equivalent of an initial capitalization of approximately \$325 million.⁴⁰ As of the end of 2016, the Bank of North Dakota had an actual equity capital of \$875 million.⁴¹ The Massachusetts report examined a state-wide public bank and determined that, adjusting for the size of the Massachusetts economy, the equivalent capital for Bank of North Dakota in Massachusetts would amount to about \$3.6 billion.⁴² Proposed legislation from 2012 for a state-wide public bank in Hawaii initially included plans to issue \$500 million worth of bonds to capitalize its proposed public bank.⁴³

As noted above, the capital requirements of a public bank will depend upon the anticipated asset size, the projected operating expense, the source and stability of deposit funding, the nature of the loan portfolio and a myriad of other factors. In 2012, Assembly Bill 2500, proposing the establishment of a California investment trust, was introduced to the California legislature. An investment trust is a form of public bank designed to exercise certain powers relating to banking, including, among others, receiving and managing deposits from public funds, loaning money, engaging in financial transactions, and buying and selling federal funds.⁴⁴ The bill was met with opposition by the California banking sector, including the California Bankers Association and the California Independent Bankers.⁴⁵ A statement by the then-California State Treasurer noted that the capitalization requirements for a public bank in California would “further complicate the state’s ability to meet its obligations, especially while the state continues to suffer from structural imbalances of revenues and expenditures, resulting in chronic shortages of cash and scarce reserves.”⁴⁶ The Chiang Report notes that some of the obstacles likely to stand in the way of creating a public banking in California include unknown start-up costs, investments that are likely to

³⁹ At least one advocate for public banking has argued that equity capital is not needed, but that is a minority position. See generally Ellen Hodgson Brown, *The Public Bank Solution: From Austerity to Posterity* (2013).

⁴⁰ The Federal Reserve Bank of Boston, *The Bank of North Dakota: A model for Massachusetts and other states?* 25 (2011), <https://www.bostonfed.org/publications/new-england-public-policy-center-research-report/2011/the-bank-of-north-dakota-a-model-for-massachusetts-and-other-states.aspx>.

⁴¹ Bank of North Dakota Financial Statements December 31, 2016, page 3, https://bnd.nd.gov/pdf/2016_bnd_annual_report.pdf.

⁴² The Federal Reserve Bank of Boston, *The Bank of North Dakota: A model for Massachusetts and other states?* 25 (2011), <https://www.bostonfed.org/publications/new-england-public-policy-center-research-report/2011/the-bank-of-north-dakota-a-model-for-massachusetts-and-other-states.aspx>.

⁴³ Keeley Webster, *California, Hawaii Aim to Replicate North Dakota’s Model State Bank*, The Bond Buyer (Mar. 12, 2012), <https://www.bondbuyer.com/news/california-hawaii-aim-to-replicate-north-dakotas-model-state-bank>.

⁴⁴ Cal. Assembly Comm. on Banking and Fin., AB 2500 (Hueso), Apr. 23, 2012.

⁴⁵ *Id.*

⁴⁶ Cal. Assembly Comm. on Banking and Fin., S. 2011-2012, at 12 (2012).

measure up in the billions of dollars, and the probability of losses for several years or more that taxpayers would have to recover.⁴⁷

d. Public Banking Movement in California

Various groups in California are considering the viability of the public banking model and conducting feasibility studies. For instance, the Oakland City Council Finance and Management Committee approved funding for a feasibility study for a public bank that might serve the City of Oakland.⁴⁸ Additionally, the concept of a public bank in California has begun to be meshed with the pressing need for state legal cannabis businesses to have access to the banking sector. The Cannabis Working Group established by John Chiang and which recently issued the Chiang Report has received testimony on whether a public bank model might work in California. Unlike the earlier attempt to introduce a bill on public banking in California, which was opposed by the California banking sector, the Cannabis Working Group has members of the banking sector and the California Banking Association as part of its membership.

One of the key recommendations of the Chiang Report is that the Attorney General of the State of California would conduct a feasibility study to assess whether it is advisable to create a public bank that, as part of its business model, would provide financial services to state legal cannabis businesses.⁴⁹ While municipalities generally are considering a public bank that would be owned by and serve a city, the Chiang Report contemplates a public bank that would be state-wide. In addition to examining the costs, benefits risks and regulatory issues and providing a legal analysis addressing the legality and associated legal risks of creating a public cannabis financial institution, the feasibility study would also examine various ownership structures, including one that would be a combination of public and private ownership and another that, like the federal Fannie Mae and Freddie Mac models, would receive a special charter from the state.⁵⁰ Regardless of which structure is decided upon, the Chiang Report takes the view that a state-wide retail branch network would be required in order to cut the flow of cannabis cash.⁵¹

The Chiang Report also recommends a feasibility study on a bankers' bank and a corporate credit union. The classic way that a bankers' bank or a corporate credit union operates is as a bank owned by other banks or a credit union whose members are other credit unions and which operates solely to provide banking services (deposits, loans or payment services) to other banks or credit unions.⁵² As described in the Chiang Report,

⁴⁷ State Treasurer's Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 3–4 (2017).

⁴⁸ Ken Epstein, *Council Committee Approves Study for a Public Bank of Oakland*, *Oakland Post*, June 13, 2017, <http://www.oaklandpost.org/2017/06/13/council-committee-approves-feasibility-study-public-bank-oakland/>.

⁴⁹ State Treasurer's Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 21 (2017).

⁵⁰ *Id.* at 18.

⁵¹ *Id.*

⁵² As discussed above, the Bank of North Dakota shares some features of a bankers' bank but is not a true bankers' bank. An example of a classic bankers' bank would be CLS Bank (real time gross settlement of foreign exchange) or DTCC (securities clearance and settlement). During the financial crisis, many corporate credit

however, the bankers' bank or corporate credit union seem more akin to a shared industry compliance portal. In this respect, the concept shares some characteristics with the shared anti-money laundering and BSA industry utility that The Clearing House has been proposing for some time.⁵³

e. Background on Banking the Cannabis Sector

This section describes the growing tension around banking the cannabis sector due to the direct conflict between the legalization of cannabis for medical and recreational use under state law⁵⁴ even as cannabis remains criminalized under the Controlled Substances Act.⁵⁵ The Controlled Substances Act, by virtue of the Supremacy Clause of the U.S. Constitution, makes it illegal under the anti-money laundering laws for banks to aid and abet a cannabis business.⁵⁶ Notwithstanding this direct conflict, sympathetic attitudes at the federal administrative level toward state level legalization of cannabis during the Obama Administration, prompted the piecemeal and patchwork issuance of regulatory guidance and proposed legislation in recent years and perhaps created some practical "breathing room" for smaller banks to provide some services to state-legal cannabis businesses.

Despite the growth of the state legal cannabis sector, most state legal cannabis businesses have what the Chiang Report describes as only "sporadic" access to banking services.⁵⁷ In light of the federal statutes against money laundering and the criminal liability that attaches to aiding and abetting activities that are crimes under federal law, as well as the history of enforcement and fines in the anti-money laundering arena, most payments providers are effectively prevented from providing banking services to cannabis businesses, and the Federal Reserve itself has refused to do so. The relevant statute subjects banks and payment systems providers to the risk of criminal liability and provides that "whoever aids, abets, counsels, commands, induces or procures" a federal crime, or "causes" a federal criminal act to be done, "is punishable as a principal."⁵⁸ The Bank Secrecy Act (the

unions, including the two largest, failed due to risky investments in subprime mortgages. Since that time, there has been a decline in corporate credit union failure due to efforts by the NCUA to stabilize this system. See National Credit Union Administration, *Stability Through the Crisis*, 6 (2009); see also Aaron Klein, 'Everyone' is the wrong way to define credit union members, Brookings (July 12, 2017), <https://www.brookings.edu/opinions/everyone-is-the-wrong-way-to-define-credit-union-members/>.

⁵³ See The Clearing House, *A new Paradigm: Redesigning the U.S. AML/CFT Framework to Protect National Security and Aid Law Enforcement* (Feb. 2017), https://www.theclearinghouse.org/~/media/TCH/Documents/TCH%20WEEKLY/2017/20170216_TCH_Report_A ML_CFT_Framework_Redesign.pdf.

⁵⁴ At least 26 states and the District of Columbia have laws legalizing some form of cannabis use. See *Governing the States and Localities, State Marijuana Laws in 2017 Map*, <http://www.governing.com/gov-data/state-marijuana-laws-map-medical-recreational.html>. Recreational cannabis has also become legal in Canada with mid to late 2018 set as the date for transition to a fully legal framework in banking and otherwise.

⁵⁵ See 21 U.S.C. § 841(a)(1) ("[I]t shall be unlawful for any person knowingly or intentionally . . . to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance.") Cannabis is a controlled substance. 21 U.S.C. § 802(6), 812 (Schedule I)(c)(10).

⁵⁶ U.S. Const. art. VI, § 2.

⁵⁷ State Treasurer's Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 1 (2017).

⁵⁸ 18 U.S.C. 2 (2015).

“BSA”) and anti-money laundering statutes and regulations are strictly enforced, and banking institutions have received large fines for violations of these laws.⁵⁹ Banks that might otherwise wish to provide banking services to cannabis businesses face high regulatory risk, and as a result, the vast majority of banks have so far avoided the cannabis sector.⁶⁰ According to one source, in 2016, only 301 banks and credit unions (which represent less than 3% of the United States banks and credit unions) worked directly with the cannabis business,⁶¹ and, as a result, “cannabis businesses are generally unable to write checks, make and receive electronic payments, or accept credit and debit cards.”⁶² These laws would also apply to a public bank in California and would require the public bank to weigh the risks and consequences of acting in violation of the federal statutes.

States have a strong public interest in making certain that state legal cannabis businesses operate in a legal manner and fully pay their taxes.⁶³ State legal cannabis businesses desire to operate openly within the legal system in light of all of the benefits that accrue to a legal operating model for a business. State law enforcement officials have raised concerns about the risk of robbery to cannabis businesses that must operate in a cash-dominant environment.⁶⁴ The Chiang Report notes that the lack of access to banking services “forces cannabis businesses to deal in large amounts of cash, which makes targets for assaults and puts the general public in danger” and that “security and procedural concerns about handling massive amounts of cash also create a nightmare for state and local government revenue-collecting agencies.”⁶⁵ These factors provide an impetus to bringing cannabis businesses into the banking system.

At least one commentator has expressed the view that the lack of stable access to the banking system is “inadequate for a swiftly-growing, multi-billion dollar industry.”⁶⁶ Initial efforts are focused on permitting cannabis businesses to obtain access to basic deposit accounts and indirect access to the payments system. Even those banks that are willing to

⁵⁹ The Financial Crimes Enforcement Network (“FinCEN”), a division of the U.S. Department of the Treasury, has authority to seek substantial civil money penalties from financial institutions and individuals who violate the BSA, and these fines often reach well into the millions of dollars. See Julie Andersen Hill, *Banks, Marijuana, and Federalism*, 65 Case W. Res. L. Rev. 597, 615 (2015) (citing to 31 U.S.C. § 5321(a)(2) (2012) (granting authority to the Secretary of the Treasury to seek civil penalties); See also 31 C.F.R. § 1010.810(d) (2014) (delegating authority from the Secretary of the Treasury to FinCEN); See, e.g., *JPMorgan Chase Bank, N.A.*, No. 2014-1 (Jan. 7, 2014) (consenting to the assessment of a \$461 million civil penalty imposed by FinCEN for failing to report suspicious transactions associated with Bernard Madoff’s Ponzi investment scheme), http://www.fincen.gov/news_room/ea/files/JPMorgan_ASSESSMENT_01072014.pdf.

⁶⁰ Arcview Market Research, *The State of Legal Marijuana Markets* (5th ed. 2017) at 14.

⁶¹ *Id.*

⁶² State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 2 (2017).

⁶³ State tax departments have experienced difficulty in taking tax payments delivered in bundles of cash. See Clay Dillow, *Paying taxes in cash, marijuana companies have a lot to hash out with the IRS*, CNBC, (April 18, 2017, 9:59 AM), <http://www.cnbc.com/2017/04/18/marijuana-companies-sending-a-huge-cash-roll-to-irs-on-tax-day.html>.

⁶⁴ Julie Andersen Hill, *Banks, Marijuana, and Federalism*, 65 Case W. Res. L. Rev. 597, 601 (2015).

⁶⁵ State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 1 (2017).

⁶⁶ Arcview Market Research, *The State of Legal Marijuana Markets* (5th ed. 2017) at 14.

provide deposit accounts and indirect access to the payments system remain reluctant to make loans.⁶⁷ Among other risks, enforcing such a loan in the court system is fraught with risk. Further, the fact that cannabis businesses do not benefit from the federal Bankruptcy Code increases the risk to bank lenders.⁶⁸

i. Federal Regulatory Guidance

Because removing cannabis from its current classification as a Schedule I drug would require action by Congress or the U.S. Attorney General,⁶⁹ in 2013, the Obama Administration's Department of Justice issued the "Cole Memo."⁷⁰ Acknowledging the tension inherent as a result of the trend towards state legalization of cannabis, the Cole Memo, as a matter of prosecutorial discretion, limits the scope of federal cannabis enforcement to areas of particular concern, which largely excludes state-legalized adult usage.⁷¹ The Cole Memo conditions its guidance by requiring states and local governments that have enacted laws authorizing cannabis-related conduct to implement "strong and effective regulatory and enforcement systems that will address the threat those state laws could pose to public safety, public health and other enforcement interests."⁷²

Importantly, the Cole Memo did not change the Controlled Substance Act, and it did not decriminalize cannabis for purposes of federal law. The Cole Memo is not a regulation and does not have the force of law. Instead, it elucidates a principle of prosecutorial discretion that federal prosecutors would not enforce an otherwise valid federal criminal law in certain circumstances. The practical result of the Cole Memo was a détente between law enforcement at the federal level and state level where state law contradicted federal law. The continued status of the Cole Memo is an open question under the Trump

⁶⁷ Sophie Quinton, *Why Marijuana Businesses Still Can't Get Bank Accounts*, The Pew Charitable Trusts, (March 22, 2016), <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2016/03/22/why-marijuana-businesses-still-cant-get-bank-accounts>.

⁶⁸ Moses Fali-Velasquez, *Changes Needed to Protect Banking and Financial Services When Dealing with the Marijuana Industry*, Lexis Practice Advisor J., August 3, 2016 (citing to *In re Medpoint Mgmt.*, 528 B.R. 178 (Bankr. D. Ariz. 2015); see also *In re Arenas*, 514 B.R. 887, 895 (Bankr. D. Colo. 2014) (The court dismissed a Chapter 7 case and denied conversion to a Chapter 13 case. The court stated that it "cannot force the Debtors' Trustee to administer assets under circumstances where the mere act of estate administration would require him to commit federal crimes under the Controlled Substances Act. Nor can the Court confirm a reorganization plan that is funded from the fruits of federal crimes.").

⁶⁹ John Hudak and Grace Wallack, *How to Reschedule Marijuana and Why It's Unlikely Anytime Soon* Brookings Institute (Feb. 13, 2015), <https://www.brookings.edu/blog/fixgov/2015/02/13/how-to-reschedule-marijuana-and-why-its-unlikely-anytime-soon/>.

⁷⁰ Mem. from James M. Cole, Deputy Att'y Gen., to United States Att'ys, Guidance Regarding Marijuana Enforcement (Aug. 29, 2013), http://www.justice.gov/iso/opa/resources/305201382_9132756857467.pdf.

⁷¹ The Cole Memo listed the Obama Administration's priorities related to the enforcement of laws involving cannabis: preventing the distribution of cannabis to minors; preventing revenue from the sale of cannabis from going to criminal enterprises, gangs and cartels; preventing the diversion of cannabis from states where it is legal under state law in some form to other states where it is illegal; preventing state-authorized cannabis activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity; preventing violence and the use of firearms in the cultivation and distribution of cannabis; preventing drugged driving and the exacerbation of other adverse public health consequences associated with cannabis use; preventing the growing of cannabis on public lands; and preventing cannabis possession or use on federal property. *Id.*

⁷² *Id.* at 2.

Administration.⁷³ Attorney General Sessions has indicated that the Cole Memo is “valid,” though his ultimate enforcement decisions are still unclear as he has made other statements critical of cannabis and lax drug enforcement generally.⁷⁴ In a letter to the Governor and Attorney General of Washington from July 2017, Attorney General Sessions suggested that the State of Washington falls short of meeting the condition under the Cole Memo that requires states that have legalized cannabis to implement adequate regulatory structures. The memo may signal that the Trump Administration will more strictly enforce the Cole Memo requirements going forward.⁷⁵

After the Cole Memo, and as part of the Obama Administration’s sympathetic attitude towards the state level legalization of cannabis, FinCEN also issued guidance (the “**FinCEN Guidance**”) on compliance with applicable laws, regulations and regulatory practice, including the BSA.⁷⁶ The FinCEN Guidance attempted to clarify how banks and other financial institutions could provide banking services to cannabis businesses and still remain consistent with their obligations under the BSA.⁷⁷ Much like the Cole Memo, the FinCEN Guidance does not change the underlying illegality of cannabis and cannabis businesses under federal law, nor does it change the fact that these businesses are determined to be high-risk. Furthermore, these federal guidelines do not have the force of law, can be withdrawn at any time and do not guarantee that the U.S. government will not take action against financial institutions that follow their rules.⁷⁸ As a result, notwithstanding the FinCEN Guidance, banks and other money services businesses dealing with the cannabis industry

⁷³ A subcommittee of the Department of Justice’s Task Force on Crime Reduction and Public Safety was established in April 2016 to undertake a review of existing federal cannabis policies to “ensure consistency with the Department’s overall strategy on reducing violent crime.” See *Update on the Task Force on Crime Reduction and Public Safety*, The Office of the Att’y Gen. (April 5, 2017), <https://www.justice.gov/opa/press-release/file/955476/download>.

⁷⁴ See *Sessions Calls Cole Memo ‘Valid,’ Says Fed Resources Are Limited*, Leafly (Mar. 16, 2017), <https://www.leafly.com/news/politics/sessions-calls-cole-memo-valid-says-fed-resources-limited>; *AG Sessions: Cole Memo is Valid, But Skeptical of Medical Cannabis*, Cannabis Industry Journal (Mar. 16, 2017), https://www.cannabisindustryjournal.com/news_article/ag-sessions-cole-memo-is-valid-but-skeptical-of-medical-cannabis/.

⁷⁵ Letter from Jefferson B. Sessions III, U.S. Att’y Gen., to Jay Inslee, Wash. Governor, and Robert Ferguson, Wash. Att’y Gen., (July 24, 2017), http://www-dev.governor.wa.gov/sites/default/files/8%202%2017%20Ltr%20from%20J%20Sessions.pdf?utm_medium=email&utm_source=govdelivery.

⁷⁶ Dep’t of the Treasury, Fin. Crimes Enf’t Network, *BSA Expectations Regarding Marijuana-Related Businesses*, (Feb. 14, 2014), <https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001.pdf>.

⁷⁷ Specifically, the FinCEN Guidance provides that in assessing the risk of providing services to cannabis businesses, a financial institution should conduct due diligence that includes: (1) verifying with the appropriate state authorities whether the business is duly licensed and registered; (2) reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate as a cannabis business; (3) requesting from state licensing and enforcement authorities available information about the business and related parties; (4) developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (e.g., medical versus recreational customers); (5) ongoing monitoring of publicly available sources for adverse information about the business and related parties; (6) ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance; and (7) refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk. *Id.*

⁷⁸ State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 7–8 (2017).

will still be required to file suspicious activity reports for transactions involving these businesses which may be passed on to federal agencies and law enforcement authorities. Some bankers have stated that the FinCEN Guidance is impracticable and that compliance with it is so difficult that even those banks that might be willing to take the risk will not do so.⁷⁹ As the Chiang Report noted, the Cole Memo and FinCEN Guidance may have opened a “narrow and fragile” path for cannabis banking, but because they do not offer a safe harbor from federal law and most financial institutions view the requirements as too burdensome to make cannabis banking worthwhile, they provide only an impartial solution.⁸⁰

ii. Bills Introduced into Congress

In an attempt to solve the issues associated with state legal cannabis businesses and their inability to obtain banking services and access payment systems, the SAFE Act was introduced in the U.S. House of Representatives on April 27, 2017.⁸¹ The SAFE Act would prohibit the federal banking regulators⁸² from penalizing depository institutions that serve state legal cannabis businesses through either: (1) terminating or limiting their deposit insurance or (2) prohibiting, penalizing, or otherwise discouraging depository institutions from providing financial services to state legal cannabis businesses. The SAFE Act would also immunize banks and their officers, directors and employees from prosecution under federal law solely for providing financial services to state legal cannabis businesses pursuant to the law or for investing any income derived from providing such financial services.⁸³ The SAFE Act would amend the BSA to require that financial institutions and their directors, officers, employees and agents comply with any guidance issued by FinCEN related to suspicious activity reports regarding state legal cannabis businesses. The SAFE Act provides that any such guidance must be consistent with the purpose and intent of the SAFE Act and must not inhibit the provision of financial services to state legal cannabis businesses.⁸⁴

⁷⁹ See Kevin Wack, *Pot Banking Conundrum Stymies California*, *American Banker* (July 10, 2017). Panel conducted at the meeting of the Cannabis Banking Working Group, San Diego, CA, <https://www.facebook.com/CaliforniaSTO/videos/vb.356962197807214/753045604865536/?type=2&theater>.

⁸⁰ State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 3 (2017).

⁸¹ The SAFE Act is the most recent in a series of bills proposed in Congress to address the problems faced by banks that wish to provide banking services to state legal cannabis businesses. It was previously introduced in both 2013 and 2015 as the Marijuana Business Access to Banking Act. See *Marijuana Businesses Access to Banking Act of 2013*, H.R. 2652, 113th Cong. (2013); *Marijuana Businesses Access to Banking Act of 2015*, H.R. 2076, 114th Cong. (2015). See also Whitney Snyder, *Long Overdue Banking Act Reintroduced in House*, *Cannabis Law PA* (May 19, 2017), <http://cannabislawpa.com/long-overdue-banking-act-reintroduced-in-house/>.

⁸² The term “federal banking regulators” for purposes of the SAFE Act includes the Federal Reserve Board, FDIC, Office of the Comptroller of the Currency (the “OCC”), National Credit Union Administration (the “NCUA”), Consumer Financial Protection Bureau, and any other regulator as determined by the Secretary of the Treasury. Even though they are part of the Federal Reserve System, because the Federal Reserve Banks are separately chartered and technically separate from the Federal Reserve Board, it remains unclear based on the text of the SAFE Act whether the Federal Reserve Banks would be subject to that law.

⁸³ See SAFE Act of 2017, H.R. 2215, 115th Cong. (2017).

⁸⁴ *Id.*

Another proposed bill, the Respect State Marijuana Laws Act of 2017, introduced in February 2017 by Representative Rohrabacher, along with six Republicans and six Democrats, would amend the Criminal Substances Act to provide that the provisions of the Act related to cannabis do not apply to any person acting in compliance with state laws relating to the production, possession, distribution, dispensation, administration or delivery of cannabis.⁸⁵ Passage of the Act would thus bar federal officials from prosecuting cannabis consumers and businesses under the Criminal Substances Act in states where recreational or medical cannabis use is legal. The Act does not directly address or provide a safe harbor for banking.

In addition, the Rohrabacher-Farr amendment, first introduced in 2003 and passed on December 16, 2014, prohibits the Department of Justice from spending money on cannabis prosecutions in states where medical cannabis is legal at the state level.⁸⁶ As a budget amendment, it must be approved every year. Thus far, the amendment has been approved every year, but continued passage is in doubt. Some commentators hope that The Rohrabacher-Farr protections could possibly be expanded to cover recreational cannabis usage even in those states where medical cannabis has not been legalized.⁸⁷ Attorney General Sessions is opposed to the Rohrabacher-Farr amendment and sent a letter to congressional leadership reaffirming the Department of Justice's opposition to the inclusion of the amendment in appropriations legislation. On September 6, 2017 the House Rules Committee blocked a floor vote on the amendment.⁸⁸ On September 8, President Trump signed a \$15 billion emergency aid package for victims of Hurricane Harvey which extended the current federal budget, including the Rohrabacher-Farr amendment, until December 8, at which point it will be voted upon by Congress to determine whether it will be renewed for the upcoming fiscal year.⁸⁹

II. Discussion

This section analyzes the feasibility of establishing a public bank in California under either the Traditional Public Bank Business Model or Traditional Plus Cannabis Business Model against the background of the public banking movement and the growing state legal

⁸⁵ See Respect State Marijuana Laws Act of 2017, H.R. 975, 115th Cong. (2017).

⁸⁶ Arcview Market Research, *The State of Legal Marijuana Markets* (5th ed. 2017) at 11.

⁸⁷ *Id.*

⁸⁸ See Christopher Ingraham, *Jeff Sessions personally asked Congress to let him prosecute medical-marijuana providers*, *The Washington Post* (June 13, 2017), https://www.washingtonpost.com/news/wonk/wp/2017/06/13/jeff-sessions-personally-asked-congress-to-let-him-prosecute-medical-marijuana-providers/?utm_term=.5f3d79bda6c6; Jeremy Berke, *The House Rules Committee Just Blocked a Vote on a Critical Cannabis Amendment*, *Business Insider* (Sept. 7, 2017), <http://www.businessinsider.com/house-rules-committee-blocks-vote-on-rohrabacher-blumenauer-amendment-2017-9>.

⁸⁹ See John Schroyer, *Rohrabacher-Blumenauer Amendment Extended Until December*, *Marijuana Business Daily* (Sept. 8, 2017), <https://mjbizdaily.com/rohrabacher-blumenauer-amendment-extended-december/>. See also Mike Debonis & Kelsey Snell, *Trump Signs \$15 Billion Harvey Aid Package After Republicans Booed Top White House Officials*, *Washington Post* (Sept. 8, 2017), https://www.washingtonpost.com/powerpost/house-set-to-vote-today-on-harvey-aid-package-that-would-also-raise-debt-ceiling/2017/09/08/728ddce8-9494-11e7-8754-d478688d23b4_story.html?hpid=hp_hp-banner-low_harveyaid-11a%3Ahomepage%2Fstory&utm_term=.2cbeecbc3d87.

cannabis sector. It is a deeper technical legal analysis of many of the legal issues mentioned in the Chiang Report.⁹⁰

1. What bank or bank-like charters are available under California law for a public bank?

a. Commercial Bank Charter

Under California law, a charter is required to take deposits.⁹¹ As there is no California law equivalent to the North Dakota statute authorizing the establishment of a public bank pursuant to a Public Bank Charter, one path under California law would be for the public sector investors to attempt to use a Commercial Bank Charter. This would require convincing the California Department of Business Oversight, the sole current authority for chartering a state private sector banking business in California,⁹² to issue such a charter. Fitting the public bank business model into a Commercial Bank Charter would be challenging. It would require the approval of the California Department of Business Oversight, a sound business plan, experienced management and appropriate capitalization. As discussed below, a commercial bank would also require approval from the FDIC, something that has proven difficult. Using a Commercial Bank Charter would in many ways be like putting a square peg in a round hole by forcing the public shareholders of the proposed public bank to retrofit the Public Bank Business Model into a regulatory system that was designed for private sector investors.

To obtain a Commercial Bank Charter, the proposed organizers of the bank must file an application with the California Department of Business Oversight, and the proposed bank may not begin its operations until its charter has been approved by that Department.⁹³ It is common for bank charter applications to take a year or more to be approved. Given the complexity and rigor of the application for a Commercial Bank Charter, the novelty of using a Commercial Bank Charter for a public bank and the tension between federal and state law with respect to providing financial services for cannabis businesses, it would be prudent to submit to the commissioner of the California Department of Business Oversight a request for a written opinion on the feasibility of using a Commercial Bank Charter for a public bank before beginning the application process.

⁹⁰ The treatment of tax laws and any federal criminal asset forfeiture laws are outside the scope of this memorandum.

⁹¹ A California state bank is defined as a corporation incorporated under the Corporations Code that is, with the approval of the commissioner, incorporated for the purpose of engaging in, or that is authorized by the commissioner to engage in, the banking business. Cal. Fin. Code § 1004; Cal. Fin. Code § 1043. It is unlawful to engage in or transact banking business within California except by means of a corporation duly organized for that purpose. Cal. Fin. Code § 1005.

⁹² Cal. Fin. Code § 1043 ("It shall be unlawful to accept payment of subscriptions for shares of any corporation proposing to engage in the banking or trust business unless authority to organize such corporation has been granted by the commissioner [of the California Department of Business Oversight].").

⁹³ See Cal. Fin. Code §1020; See also *Application for Authority to Organize Bank*, State of California Department of Business Oversight (2012), http://www.dbo.ca.gov/forms/trust_companies/Form10.pdf.

Each application for a Commercial Bank Charter in California must provide detailed information about the proposed bank's business plan, management and organizing group.⁹⁴ California law requires that the business plan include:

- a description of the market that the bank proposes to serve;
- a description of the services and products proposed to be offered by the bank;
- an analysis of the need for the services and products proposed to be offered by the bank;
- a description of competition in the proposed market of the bank, including the name of each other business which provides to the proposed market of the bank, including the name of each other business which provides to the proposed market services and products that are similar to any of the principal services and products offered by the bank;
- a description of how services and products of the bank will be marketed in consideration of the existing and anticipated competition;
- an analysis of the capital, financial, physical and human resources required by the bank to successfully implement the proposed business plan; and
- in case any material element of the business plan is based on an assumption, a statement of the assumption and justification for the assumption.⁹⁵

The application must also include information regarding proposed directors and executive officers. Each director, executive officer and 10% shareholder must submit detailed biographical and financial reports, and fingerprinting may be required. Individuals proposed to be executive officers must have appropriate character, demonstrated banking experience and business qualifications. Proposed directors must have reputations of honesty and integrity within the community where the bank will be located and must have demonstrated experience in financial affairs, supported by descriptions of relevant banking experience. For each proposed director, the application must include descriptions of how

⁹⁴ Any *de novo* bank would also need to meet business plan requirements in connection with the application for deposit insurance from the FDIC. The FDIC requires that a bank operate within the parameters of the business plan submitted to the FDIC in connection with its application for deposit insurance during the first three years of operations. The *de novo* bank must seek the prior approval of the appropriate Regional Director, if not the FDIC, for any proposed major deviation or material change from the submitted business plan. FDIC, Applying for Deposit Insurance: A Handbook for Organizers of *De Novo* Institutions (Apr. 2017), at App. 2.

⁹⁵ Cal. Code Regs. tit. 10, § 10.3155.

the proposed director intends to serve the proposed bank and relevant qualifications to implement such intentions.⁹⁶

Upon receiving an application for a Commercial Bank Charter, the commissioner of the California Department of Business Oversight has wide discretion in granting or denying the charter. The commissioner is responsible for making the decision whether to approve each application and will not approve an application until he or she has ascertained that:

- the public convenience and advantage will be promoted by the establishment of the proposed bank;
- the proposed bank will have a reasonable promise of successful operation;
- the bank is being formed for no other purpose than the legitimate objects contemplated;
- the proposed capital structure is adequate;
- the proposed officers and directors have sufficient banking experience, ability and standing to afford reasonable promise of successful operation;
- the name of the proposed bank does not resemble, so closely as to be likely to cause confusion, the name of any other bank or trust company transacting business in California or which had previously enacted business in California; and
- the applicant has complied with all of the applicable provisions.⁹⁷

In addition to a commercial bank, we have also considered other legal entity types under California law that may be available for a public bank. We have excluded a trust company from consideration as it could only take trust deposits and would be very limited in its activities.⁹⁸ We have excluded a California Benefit Corporation, since it cannot take deposits.⁹⁹ While we have examined the industrial bank and loan company, it appears to provide no significant benefits over that of a commercial bank and presents the same sorts of challenges.¹⁰⁰

⁹⁶ Cal. Code Regs. tit. 10, §§ 10.3159, 10.3160; See also, California Department of Business Oversight, *Guide for Groups Interested in Chartering a State Bank in California*, <http://www.dbo.ca.gov/cacharter/guide.asp>.

⁹⁷ Cal. Fin. Code § 1023.

⁹⁸ Under California law, the term “trust company” means a corporation, industrial bank, or a commercial bank that is authorized to engage in the trust business. Cal. Fin. Code § 117. An application to establish a trust company must meet the same requirements regarding commercial and industrial bank applications.

⁹⁹ California Benefit Corporations are another corporate form specifically designed for benefitting a public purpose, but it would not be feasible since, because it is not established pursuant to a bank charter, it would not be able to take deposits. Cal. Corp. Code § 14600-14604 (2012).

¹⁰⁰ Industrial loan companies are institutions that are authorized to make loans and take deposits much like banks and may be controlled by companies. Cal. Fin. Code § 1541. An application for an industrial bank must

b. Credit Union Charter

We have also considered whether the Credit Union Charter might be a suitable charter for a public bank under either the Traditional Public Bank Business Model or the Traditional Plus Cannabis Business Model.¹⁰¹ There are two possible alternatives for a Credit Union Charter. Under the first model, the City of San Francisco could be the sponsoring organization, contributing the funds necessary for organization and operation of the credit union. The credit union would have to obtain sufficient members satisfying the common bond requirement as discussed below. Alternatively, the City of San Francisco could be a member, and potentially solicit other municipalities to satisfy the common bond requirement.¹⁰² California law contemplates that there must be 500 members in order to charter a credit union, but it appears that the commissioner of the California Department of Business Oversight may approve a charter with fewer than that number.¹⁰³ We are aware that the California Department of Business Oversight previously has not interpreted the 500 members to be discretionary.¹⁰⁴

The statute also provides that California credit unions must apply for and obtain federal deposit insurance or other insurance that is not unsatisfactory to the commissioner of the California Department of Business Oversight.¹⁰⁵ If a California credit union could obtain private deposit insurance, neither the NCUA nor any federal banking regulator would have jurisdiction over the credit union or its operations.¹⁰⁶ It is not known whether either a private deposit insurance company such as American Share Insurance would be open to the possibility of insuring such an institution, or whether the California Department of Business Oversight would accept such insurance. A California credit union with private deposit insurance would avoid some of the federal banking law issues faced by a public bank using a Commercial Bank Charter. In addition, a California state-chartered credit union with private insurance would not be subject to the 12.25% limit on business loans applicable to

meet the requirements described above regarding commercial bank applications, and, therefore, a public bank organized under an industrial loan company charter would have the same hurdles as one organized under a Commercial Bank Charter.

¹⁰¹ A number of institutions that have publicly expressed a desire to provide banking services to the cannabis industry are credit unions. Examples of such credit unions include the Salal Credit Union in Washington and Fourth Corner in Colorado.

¹⁰² Under California law, a credit union must be based on, among other things, a group of persons with a common bond beyond obtaining financial services from the credit union. There are three basic forms of groups eligible for membership in a credit union: groups based upon a common bond of occupation; groups based upon a common bond of association; and groups within a well-defined neighborhood, community, or rural district. Cal. Code. Regs. tit. 10, § 30.51.

¹⁰³ Cal. Fin. Code § 14155 (stating that the commissioner “may” deny the application for a credit union if the number of persons eligible for membership is less than 500).

¹⁰⁴ See California Department of Business Oversight, *Organizing a State Credit Union: Information Booklet* (2013), http://www.dbo.ca.gov/forms/credit_unions/DBO391.pdf, at 2.

¹⁰⁵ Cal. Fin. Code § 14858 (“Every credit union shall apply for and obtain insurance as provided for by [the NCUA], or other insurance or guaranty of shares that is not unsatisfactory to the commission [of the Department of Business Oversight].”).

¹⁰⁶ See 12 U.S.C. § 1752 *et. seq.*

federally insured credit unions.¹⁰⁷ A credit union with a Traditional Plus Cannabis Business Model would have the same difficulty in opening a Federal Reserve Bank master account. As with a Commercial Banking Charter, it would be prudent to submit to the commissioner of the California Department of Business Oversight a request for a written opinion on the feasibility of using a Credit Union Charter with private share insurance.

c. Observations

We expect that the California Department of Business Oversight will examine any application for a Commercial Bank Charter or Credit Union Charter with great care and will want to have a high level of comfort on the California constitutional, home rule and other California public law authority of the public shareholders to own a bank.¹⁰⁸ We also expect that the Department might be influenced by the litigation position of the Federal Reserve Board that a Federal Reserve Bank¹⁰⁹ may deny a master account to a depository institution that has a Traditional Plus Cannabis Business Model as a result of the prohibitions associated with its activities under applicable federal law.¹¹⁰

It is also useful to note the argument put forth by the Federal Reserve Bank of Kansas City that the Fourth Corner Credit Union charter is preempted by the federal statutes dealing with controlled substances. In our view, federal law may affect the permissible activities of a chartered depository institution, but would not preempt the authority of the state to grant a charter. The preemption argument may, nevertheless, reappear in other contexts. Finally, as noted in the Chiang Report, all other federal criminal laws would continue to apply to any such bank.¹¹¹

2. What federal banking laws would affect the ability of such a public bank to operate?

Were the public bank required to obtain federal deposit insurance, it would be subject to the full panoply of the federal laws and regulations governing operations, safety and soundness, permissible activities and similar requirements. In this section, we touch on only a few of the federal laws and regulations we believe would be the most difficult to meet: deposit insurance, bank holding company, source of strength, capital and restrictions on affiliate transactions.

¹⁰⁷ See 12 U.S.C. § 1757a (describing federal limits on “member business loan[s]”); 12 C.F.R. § 723.1(b)(1) (applying federal member-business-loan limitation to state-chartered credit unions that are federally insured); Cal. Code Regs. tit. 10 § 30.803 (same).

¹⁰⁸ Considerations of these California public law topics are outside of the scope of this memorandum. As topics for further exploration, we note the following: state constitutional law, charter cities, municipal affairs, home rule authority, open meetings, public records and fiduciary duties.

¹⁰⁹ It is the Federal Reserve Banks, not the Board of Governors, that determine whether to provide financial institutions with a master account and access to the payment systems.

¹¹⁰ Answer Brief of Appellee at 31, *The Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, No. 16-1016, (10th Cir. filed June 27, 2017).

¹¹¹ State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 4 (2017).

a. FDIC Insurance Requirements

Under California law, all state-chartered banks must obtain federal deposit insurance.¹¹² Thus, it is not possible for a Commercial Bank Charter to be granted without federal deposit insurance from the FDIC. Applications for a Commercial Bank Charter are therefore generally submitted jointly with applications for federal deposit insurance. The final decision by the California Department of Business Oversight to grant or deny the Commercial Bank Charter application is made independently of the decision to grant or deny federal deposit insurance. However, it is unusual for one to be granted without the other.

In considering applications for federal deposit insurance, the FDIC takes into account:

- the financial condition of the proposed depository institution;
- the adequacy of its capital structure;
- its future earnings prospects;
- the general character and fitness of its management;
- the risk presented by such depository institution to the deposit insurance fund;
- the convenience and needs of the community to be served by the depository institution; and
- whether its corporate powers are consistent with the purposes of the Federal Deposit Insurance Act.¹¹³

The FDIC Statement of Policy on Applications for Deposit Insurance states that if each of these factors is met, the proposed applicant will generally receive deposit

¹¹² Cal. Code Regs. tit. 10 § 10.3520 (2017). Under California law, every industrial loan company, trust company and credit union must obtain deposit insurance. Cal. Code Regs. tit. 10 § 10.3520 covers any “subject institution,” which means “any California state bank which is or is proposed to be a commercial bank or an independent trust company.” Cal. Code Regs. tit. 10 § 10.3100. In 2000, deposit-taking industrial loan companies in California were re-categorized as industrial banks within the meaning of the California Financial Code, which requires that they have insurance. SB 2148 (2000); Cal. Fin. Code § 1401 (“[e]ach industrial bank shall be an insured bank at all times while it is engaged in the industrial banking business”; “any reference in a provision of any statute or regulation of this state to banks or commercial banks includes industrial banks”). Congress has imposed a moratorium on the granting of any new FDIC insurance for industrial loan companies in 2010 and, since 2013, the FDIC has not lifted its informal moratorium policy. It is widely understood that, as a policy matter, no new industrial loan companies will be granted FDIC insurance. Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial Regulation: Law and Policy* 175 (Robert C. Clark et al. eds., 1st ed., 2016). Credit unions must obtain deposit insurance provided for by Title II of the Federal Credit Union Act, or other insurance that is satisfactory to the commissioner. Cal. Fin. Code § 14858. Federal credit unions must be insured by the National Credit Union Administration. 12 U.S.C. § 1781(a) (2012).

¹¹³ 12 U.S.C. § 1816 (2006).

insurance.¹¹⁴ It is widely understood that there is a strong discretionary element in the granting of deposit insurance. The FDIC may also conduct examinations of the proposed bank in connection with reviewing the deposit insurance application. There is no explicit requirement that the FDIC act within any certain time frame. It should be expected that such an application might take a year or more, and there are no assurances that an application would be granted.¹¹⁵

Of specific importance for any public bank, the FDIC Statement of Policy on Applications for Deposit Insurance expressly states that an application for deposit insurance for such a public bank will be reviewed “very closely,” because such institutions present “unique supervisory concerns that do not exist with privately owned depository institutions.”¹¹⁶ The policy statement states:

For example, because of their ultimate control by the political process, such institutions could raise special concerns relating to management stability, their business purpose, and their ability and willingness to raise capital (particularly in the form of true equity rather than governmental transfers). On the other hand, such institutions may be particularly likely to meet the convenience and needs of their local community, particularly if the local community is currently un- or under-served by depository institutions. In view of such considerations and the policy issues they embody, the FDIC will closely evaluate such applications to ensure the required statutory factors are met.¹¹⁷

The FDIC would carefully scrutinize the proposed bank’s application for deposit insurance. Although the FDIC has stated that it is willing to consider providing deposit

¹¹⁴ *Statement of Policy on Applications for Deposit Insurance*, FDIC, (1998), <https://www.fdic.gov/regulations/laws/rules/5000-3000.html>.

¹¹⁵ A recent FDIC proposal, open for comment through September 8, 2017, regarding its deposit insurance application procedures manual suggests that the FDIC aims to act within 120-180 days after a substantially complete application is received. *Deposit Insurance Applications Procedures Manual*, FDIC, (2017), <https://www.fdic.gov/regulations/applications/procmanual.pdf>. The lived experience is that a year’s timing would be an appropriate assumption. Keith Noreika, the acting comptroller of the currency, recently criticized the FDIC for its inaction with respect to the assessment of *de novo* charter applications. Noreika stated that “since 2001, we’ve had 14 organizers of national banks that [the OCC has] approved for a charter that have not gotten an answer, yes or no, from the FDIC” and called it “unconscionable that they spend all this money to organize a bank to go through two regulatory processes [through the OCC and the FDIC]—and they can’t even get a no out of them that they could go to court and challenge.” See Lalita Clozel, *OCC to Take First Step Toward Rolling Back Volcker Rule*, *American Banker* (July 19, 2017).

¹¹⁶ *Statement of Policy on Applications for Deposit Insurance*, FDIC, (1998), <https://www.fdic.gov/regulations/laws/rules/5000-3000.html>. This view was repeated in the FDIC’s recent proposed manual regarding processing of deposit insurance applications. See *Deposit Insurance Applications Procedures Manual*, FDIC, (2017), <https://www.fdic.gov/regulations/applications/procmanual.pdf>, App. 1, at 48.

¹¹⁷ *Id.* The New Mexico FID Memo notes that while the Statement of Policy on Applications for Deposit Insurance is “not a definitive rejection of granting deposit insurance,” it makes clear the FDIC’s concerns. Mem. from the New Mexico Regulation and Licensing Department, Financial Institutions Division, Legal Issues and Matters for Further Research and Examination Regarding Proposed Public Bank of Santa Fe (Aug. 24, 2017), https://www.santafenm.gov/media/archive_center/Item_3.pdf#page=128, at 7–8.

insurance for public banks, the text of the FDIC Statement of Policy on Applications for Deposit Insurance suggests the bar for receiving approval of such an application is high.

Based upon our experience, we believe that the FDIC would have concerns over public ownership, accountability, and the ability of the institution to obtain needed capital funds in the future. The FDIC has privately expressed concerns about its ability to exercise its enforcement authorities where a public entity is involved. In an earlier experience we had with a bank that would have been owned by a housing finance agency, these concerns eventually led to the withdrawal of the application.

However difficult it would be to obtain federal deposit insurance for a public bank operating pursuant to the Traditional Public Bank Business Model, it would be far more difficult under the Traditional Plus Cannabis Business Model. The illegality of the cannabis business under federal law makes it extremely unlikely that the FDIC would grant deposit insurance. In Colorado, the Fourth Corner Credit Union, a state-chartered credit union for the cannabis sector, was denied insurance by the NCUA, and subsequently sued the NCUA. The lawsuit, while unresolved, underscores the difficulties in obtaining federal deposit insurance particularly for institutions operated pursuant to the Traditional Plus Cannabis Business Model.¹¹⁸

Given the difficulty in obtaining a Commercial Bank Charter and FDIC insurance, the most stable legal foundation for a public bank under the Public Bank Business Model would be for the California legislature to pass a specific statute that either creates a public bank or creates the possibility of a public bank authorized pursuant to a Public Bank Charter that did not require federal deposit insurance. The Bank of North Dakota is not required under state law to have federal deposit insurance. If a similar law passed in California providing that a bank with a Public Bank Charter does not need federal deposit insurance, it would remove a key obstacle to establishing a public bank pursuant to either the Traditional Public Bank Business Model or the Traditional Plus Cannabis Business Model.

Obviously, a state guaranty similar to the one provided to the Bank of North Dakota represents a substantial contingent financial exposure. It would require willingness on the part of the California government to assume the financial risk associated with guaranteeing deposits of a public bank. Additionally, the state would need to evaluate whether any state deposit insurance scheme or guarantee of a public bank's deposits conflicts with other provisions of California state law.¹¹⁹

As discussed above, it might be possible for a state chartered credit union to obtain private deposit insurance that would be acceptable to the California Department of Business Oversight.

b. Bank Holding Company Requirements

¹¹⁸ *The Fourth Corner Credit Union v. National Credit Union Administration*, No: 1:15-cv-01634-REB. Comp. (D. Colo. 2016).

¹¹⁹ See, e.g., Cal. Const. art. XVI, § 6 (generally prohibiting the state or any political corporation or subdivision thereof to give or to lend its credit in aid of or to any person, including for the payment of the liabilities of any individual, association, municipal or other corporation).

Certain persons or entities that own or control a bank are deemed “bank holding companies” under federal law and, as a result, are subject to supervision by the Federal Reserve Board and various regulatory requirements. The Bank Holding Company Act of 1956 generally excludes from the definition of “company,” and thus from the definition of “bank holding company,” however, a direct government investor or any corporation that is majority owned by any state.¹²⁰ Therefore, a public bank owned by the State of California, as described in the Chiang Report, would not be a federal bank holding company. The language in the statute does not refer to a city, and it would be an issue of first impression with the Federal Reserve Board, but we believe that the Federal Reserve Board should also not consider a bank owned by the City of San Francisco to be a federal bank holding company.¹²¹ It would be important that this view be taken as the consequences of a municipal public bank becoming a federal bank holding company would be dire. The Bank Holding Company of 1956, for example, limits the activities of a bank holding company to those that are “closely related to banking” or “financial in nature,” requirements that a municipality could not meet. The policy purposes of these restrictions however, did not contemplate municipal ownership, hence the exception for state ownership.¹²²

California law also includes a separate definition of “bank holding company” and associated regulatory requirements.¹²³ Unlike under the federal Bank Holding Company Act of 1956, however, the definition of “bank holding company” under California law includes any “person” that controls a bank, through stock ownership or otherwise.¹²⁴ An investment by either the City of San Francisco or by the State of California in a bank with a Commercial Bank Charter may therefore trigger regulations as a bank holding company under California law. In sharp contrast to federal law, however, it appears that the consequences of being deemed a bank holding company under California law are not as onerous and involve largely reporting and examination requirements, the contours of which may be able to be worked out with the California Department of Business Oversight. It may be helpful to make a written request to the commissioner for an opinion on whether the City of San Francisco would be considered a bank holding company under California law in this context and, if so, how the relevant regulatory exam and reporting requirements would apply.

For an investment by State of California or the City of San Francisco in a bank with a Public Bank Charter, we recommend that the statute establishing the public bank specify

¹²⁰ 12 U.S.C. § 1841(b), 12 C.F.R. § 225.2(d)(2); see also Letter from the Board of Governors of the Federal Reserve System to Patricia S. Skigen and John B. Cairns (Aug. 19, 1988).

¹²¹ We assume, based on the Owen Memo, that to establish a public bank, the City of San Francisco would have to form a separate corporation for that purpose. See Mem. from Thomas J. Owen, Deputy City Att’y, to John Avalos, Member, Board of Supervisors, Municipal Bank Formation, 5 (May 15, 2013).

¹²² For a discussion of policy purposes, see Saule T. Omarova and Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 Rev. Banking * Fin. L. 113 (2011).

¹²³ A bank holding company under California law also must submit reports to and be subject to examination by the California Department of Business Oversight. See Cal. Fin Code §§ 1283, 1284.

¹²⁴ Cal. Fin Code § 1280. The relevant definition of “person” under California Law includes “an individual, sole proprietorship, partnership, joint venture, association, trust, estate, business trust, corporation, joint stock company, limited liability company, unincorporated association, *sovereign government or agency*, instrumentality, or political subdivision thereof, or any similar entity or organization.” (emphasis added) Cal. Fin. Code § 127.

whether the public bank would be subject to the federal and state statutory provisions regarding bank holding companies and, if so, how practically the regulatory requirements would apply.

The bank holding company provisions under federal and state law would not apply to the City of San Francisco's ownership interest in a credit union.

c. Source of Strength Requirements

The federal banking laws also contain a statutory obligation that any “company” that controls an insured depository institution act as a “source of strength” to the insured depository institution.¹²⁵ Regardless of whether the State of California or City of San Francisco technically are considered companies under the language of the statute, since the source of strength doctrine is a core principle of federal banking law, we suspect that the FDIC would be reluctant to grant deposit insurance to a public bank unless it had some assurances, likely from a capital maintenance or other contractual arrangement, that the policy goals of the source of strength doctrine would be satisfied. We read the references to equity capital in the FDIC Statement of Policy on Applications for Deposit Insurance to be implicit references to the source of strength doctrine.

d. Capital Requirements

A newly-established public bank would also be required to maintain a capital level higher than the regulatory minimum for at least three years under the FDIC's rules for *de novo* banks. The FDIC's manual on the deposit insurance application process states that obtaining FDIC insurance may be conditioned on the applicant's satisfaction of minimum initial capital and ongoing capital maintenance for the three-year *de novo* period.¹²⁶ Since each *de novo* bank is unique in terms of its business plan, management team, market competition and local economy, the FDIC does not prescribe a minimum dollar level of capital but instead considers the unique factors of each proposal and sets a minimum capital requirement based on an evaluation of the proposed institution's market dynamics, anticipated size, complexity, activities, concentrations and business model.¹²⁷ The FDIC will require higher capital if the proposal presents more than routine risk or novel characteristics.¹²⁸ The FDIC states that the tier 1 capital-to-assets leverage ratio should be maintained at not less than 8% during the first three years of operation, and the *de novo* bank must also maintain an adequate allowance for loan and lease losses.¹²⁹ The *de novo* bank's business plan should not assume any new or additional capital raises during the first three years beyond the initial capital contributions made during the institution's organization

¹²⁵ 12 U.S.C. § 1831o-1.

¹²⁶ FDIC, Applying for Deposit Insurance: A Handbook for Organizers of *De Novo* Institutions 34 (April 2017).

¹²⁷ *Id.* at 18

¹²⁸ For example, proposals involving monoline operations or high levels of non-core funding may need higher capital to mitigate the risks of engaging in a single line of business or operating with potentially volatile funding. *Id.* at 18.

¹²⁹ *Id.*

phase.¹³⁰ We are aware of numerous instances where a *de novo* bank was required to maintain capital at levels well above 10% for an extended period of time due to perceived risks associated with the business model.

e. Restrictions on Covered Transactions

Section 23A of the Federal Reserve Act and its implementing regulation, Regulation W, apply to transactions between an insured bank and its affiliates. The term “affiliate” includes companies that control the bank, as well as companies controlled by such companies. Strict limitations on and collateral requirements for transactions with affiliates have been referred to as the “Magna Carta” of banking law.¹³¹ While government entities are generally not considered to be companies for the purposes of the banking laws, there is a risk that the FDIC, as a condition of granting deposit insurance, may seek to regulate transactions between the bank and its affiliates. In this context, the FDIC might define the public shareholders and potentially any other California governmental entities as affiliates of the public bank.

Transactions covered by 23A and Regulation W include loans and extensions of credit by a bank to its non-bank affiliate.¹³² Therefore, if the controlling shareholder municipality attempts to borrow from the bank, the transaction could be subject to the restrictions of Section 23A and Regulation W. As a technical matter, Section 23A, like the source of strength doctrine, should not apply to public shareholders and their affiliated governmental entities.¹³³ Based upon the centrality of the affiliate limitations to banking law, however, we express concern that the FDIC might condition the grant of deposit insurance on some type of affiliate transaction limit.

The Bank of North Dakota, as a public bank without federal deposit insurance and created under a special statute, is not subject to this limitation. It makes loans to North Dakota governmental entities with some frequency. By avoiding federal deposit insurance, any limitations on transactions with affiliated entities would likely be governed by the California Department of Business Oversight.

f. Requirement that Municipal Deposits above the Insurance Limit be Collateralized

California state law, like that of many other states, requires that any California state governmental entity that deposits funds into a private commercial bank or credit union must seek collateral from that bank over the FDIC-insured amount.¹³⁴ If a Commercial Bank

¹³⁰ *Id.*

¹³¹ Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 *North Carolina Law Rev.* 5, 105, (June 2011).

¹³² Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial Regulation: Law and Policy* 234 (Robert C. Clark et al. eds., 1st ed., 2016).

¹³³ The reason is that the term “company” as used in the statute has traditionally been read to exclude direct governmental entities.

¹³⁴ Cal Gov’t Code § 53652. See also FDIC, *Deposit Insurance for Accounts Held by Government Depositors* (2013), <https://www.fdic.gov/deposit/deposits/factsheet.html>.

Charter or Credit Union Charter were used, this requirement would apply. The Bank of North Dakota is exempt from this requirement. Amending this requirement would require a modification of a California statute.

3. Would such a public bank be able to access the Federal Reserve's payments system, either directly or indirectly?

Illegal businesses tend to be cash businesses and the anti-money laundering statutes are designed to prevent cash derived from illegal activities from entering the banking sector. In today's economy, legal businesses use cash less and less and rely instead on electronic payments systems to receive or transmit funds. We are not aware of a recent example in which an entire business sector, in transitioning from an illegal business model to a legal business model, found itself partly in and partly out of the banking and payments system. The state legal cannabis sector remains either solely cash or cash dominant.¹³⁵ The current situation is neither ideal nor stable. As the Chiang Report notes, large amounts of cash make cannabis businesses, their employees and their customers targets of violent crime.¹³⁶ In addition, state and local government agencies that collect tax and fee payments in cash from the cannabis industry incur added expenses, demands on staff time and risks to employee safety.¹³⁷

In the first stage of state-level legalization, cannabis businesses concentrated on access to bank deposit accounts. The essential purpose of a bank deposit account was to lessen the risks associated with a cash-dominant business model and to have access to the banking and payments system through the ability to write checks and make direct payments to employees, vendors and tax authorities. Before the Cole Memo and the FinCEN guidance, according to media reports, many state legal cannabis businesses relied, at least in part, upon subterfuge to obtain deposit accounts. The Cole Memo and the FinCEN guidance opened up the possibility for some state legal cannabis businesses to openly obtain bank accounts. Nonetheless, only a few banks and credit unions have been willing to do so, and these are generally small banks and credit unions that already had their own direct (via a master account with the local Federal Reserve Bank) or indirect (via a correspondent banking account with a larger bank) access to the payments system.¹³⁸

Attempts by *de novo* depository institutions to have both a cannabis-dominant business model and to get direct access to the Federal Reserve's payment system have not been successful to date, although there are some lessons from these attempts that are of interest with respect to a proposed public bank in California. Colorado began by changing its law to permit the creation of a state-chartered cooperative for state legal cannabis

¹³⁵ Julie Andersen Hill, *Banks, Marijuana, and Federalism*, 65 Case W. Res. L. Rev. 600–01 (2015).

¹³⁶ State Treasurer's Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 3 (2017).

¹³⁷ *Id.*

¹³⁸ Some have added cannabis banking as a new business line. One example is Salal Credit Union, a credit union in Seattle, Washington that has been operating for 65 years and announced that in addition to its prior business lines of providing retail banking, small business services, mortgages and dealer direct lending, it would add a new business line supporting cannabis businesses. See *Cannabis Industry*, Salal Credit Union, <https://www.salalcu.org/business/cannabis-industry/>.

businesses that could take deposits but which would not be required to have FDIC insurance.¹³⁹ The Colorado cooperative statute required that the cooperative have direct access to a master account at a Federal Reserve Bank.¹⁴⁰ No cooperatives have been chartered in Colorado.

In November 2014, the Colorado Division of Financial Services granted a credit union charter to Fourth Corner, whose members envisioned a business plan that would serve Colorado state legal cannabis businesses by providing banking services to licensed cannabis businesses and cannabis legalization supporters. Immediately after its state charter became final, Fourth Corner applied to the Federal Reserve Bank of Kansas City for a master account.¹⁴¹ Fourth Corner, which operated under the Traditional Plus Cannabis Business Model, was unable to open such a correspondent account.¹⁴² For most banks and credit unions, opening a master account at a Federal Reserve Bank is a routine matter that happens quickly.¹⁴³

After almost nine months, the Federal Reserve Bank of Kansas City denied Fourth Corner's application for a master account. It cited eight reasons for the denial: (1) as a *de novo* bank, there was no historical record for the Federal Reserve Bank to review; (2) insufficient information to assess Fourth Corner's ability to safely and soundly operate; (3) insufficient information to assess Fourth Corner's ability to comply with applicable laws and regulations, including the BSA and anti-money laundering responsibilities; (4) Fourth Corner's focus on serving cannabis businesses; (5) the illegality under the Controlled Substances Act to manufacture, distribute and dispense cannabis; (6) Fourth Corner had not demonstrated its ability to conduct appropriate enhanced monitoring requirements and manage its risk appropriately with respect to its customers with cannabis businesses; (7) Fourth Corner's business model focused on a newly licensed industry with relatively immature businesses operating in an environment of evolving laws and regulations; and (8)

¹³⁹ Colo. Rev. Stat. Ann. § 11-33.

¹⁴⁰ Colo. Rev. Stat. Ann. § 11-33-104.

¹⁴¹ The Federal Reserve Banks administer four primary payment services: (1) the centralized check collection system; (2) the Automated Clearing House network for processing batched electronic small-dollar payments; (3) the Fedwire system for large electronic payments; and (4) coin and currency services.

¹⁴² "The Credit Union has one alternate path to access the Reserve Bank's services: establishing a correspondent relationship with a financial institution that already has a master account. But at oral argument in the district court, counsel for the Credit Union asserted that it tried and failed to secure a correspondent relationship." *The Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, No. 16-1016 (10th Cir. filed June 27, 2017), at 4, note 2.

¹⁴³ For direct access to a master account, a financial institution must provide a resolution from the institution's board of directors and submit forms designating certain individuals as authorized to manage the payment systems transactions of the institution. Under the Monetary Control Act of 1980, all "depository institutions," including both banks and credit unions, regardless of whether the institution is a member of the Federal Reserve System or not, may open a master account, but the decision to grant access to a master account to institutions that are not depository institutions is discretionary. See Federal Reserve, Operating Circular (2013), https://www.frb services.org/files/regulations/pdf/operating_circular_1_02012013.pdf. Julie Andersen Hill, *Banks, Marijuana, and Federalism*, 65 Case W. Res. L. Rev. 600-01 (2015). Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial Regulation: Law and Policy*, 751–802 (Robert C. Clark et al. eds., 1st ed., 2016).

Fourth Corner's lack of capital at inception would make it unable to absorb losses it may initially incur.¹⁴⁴

Fourth Corner, citing the Cole Memo and FinCEN Guidance, sued the Federal Reserve Bank of Kansas City. Noting the continued nature of cannabis as a Schedule 1 drug under the Controlled Substances Act, the district court dismissed Fourth Corner's lawsuit on the grounds that "courts cannot use equitable powers to issue an order that would facilitate criminal activity."¹⁴⁵ The district court also characterized Fourth Corner's arguments that the Cole Memo and FinCEN Guidance provide tacit approval for providing banking services to cannabis businesses as "something of a sleight of hand,"¹⁴⁶ stating that these statements suggest that "prosecutors and bank regulators might 'look the other way'"¹⁴⁷ and that the memo and guidance "does not change the law."¹⁴⁸

Fourth Corner appealed the district court's decision to the U.S. Court of Appeals for the Tenth Circuit, which, in a *per curiam* opinion issued on June 27, 2017, ruled that the district court's order was vacated and Fourth Corner's claim was dismissed without prejudice.¹⁴⁹ One judge would have largely agreed with the district court and dismissed with prejudice. A second judge was influenced by Fourth Corner's mid-litigation change of strategy in which the credit union changed its business plan so that it would now only provide banking services to cannabis businesses when and if it became legal to do so under federal law. That judge was of the view that the case was no longer ripe, as Fourth Corner would need to reapply for a master account in light of its new business plan. The third judge opined that granting the master account to Fourth Corner, or any other chartered depository institution, was not discretionary, but his opinion assumed that Fourth Corner would operate pursuant to its new business plan and would not engage in illegal activity (*i.e.*, it would not provide banking services to the cannabis industry while it was illegal to do so under federal law). The net result of the fractured views of the panel was a compromise position under which two of the three opinions from the judges on the Tenth Circuit panel affirmed the view that cannabis businesses remain illegal under federal law, but the dismissal was without prejudice.

Our view is that a well-capitalized public bank using the Commercial Bank Charter and following with the Traditional Public Bank Business Model (*i.e.*, without any cannabis activities), should, over time, be able to open a master account at its local Federal Reserve Bank. We believe that a public bank with a Public Bank Charter should qualify as a "depository institution," and to the extent it follows the Traditional Public Bank Business

¹⁴⁴ Letter from the Federal Reserve Bank of Kansas City to Fourth Corner Credit Union, (July 16, 2015).

¹⁴⁵ *The Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, 154 F. Supp. 3d 1185, 1188 (D. Colo. 2016), vacated, No. 16-1016, (10th Cir. June 27, 2017).

¹⁴⁶ *Id.* at 1189.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *The Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, No. 16-1016 (10th Cir. filed. June 27, 2017).

Model, the same conclusion should hold.¹⁵⁰ The same analysis would apply to a credit union. The Bank of North Dakota has such an account. We expect that a solid business plan and the backing of the state or municipal government will overcome the non-cannabis related reasons given for the rejection of the Fourth Corner's master account.

We believe, however, that it will be extraordinarily difficult for a public bank operating under the Traditional Plus Cannabis Business Model to open a master account with its local Federal Reserve Bank for all of the reasons that resulted in the Fourth Corner denial. Based on long experience working with the Federal Reserve System, we are of the view that neither the Federal Reserve Board nor any of the other Federal Reserve Banks will find the views of the one judge that viewed granting a master account as a nondiscretionary activity dispositive.¹⁵¹ Any such public bank would need to either await a change in federal law or be willing to sue its local Federal Reserve Bank after a denial in the hopes of a more positive outcome than that under *Fourth Corner*.¹⁵² It may be possible for a public bank operating under the Traditional Plus Cannabis Business Model to find a bank or credit union that is willing to engage in correspondent banking to give the public bank indirect access to the Federal Reserve's payment system. Although Fourth Corner was unable to find such a bank or credit union, a well-capitalized public bank with a solid business plan may be in a different scenario. Of course, much will depend upon whether the Trump Administration continues the Cole Memo and the FinCEN Guidance.

It is unclear whether the SAFE Act would completely solve the problem of a master account for a *de novo* public bank. We believe that the policy behind the SAFE Act is intended to do so, but its actual language could be improved. The text of the bill speaks solely to preventing any "terminations" or actions against banks that provide services to cannabis businesses. It does not explicitly speak to providing charters, federal deposit insurance or master accounts to *de novo* banks. In light of *Fourth Corner*, it would make sense to clarify the intent, either through a language change or through legislative history.

Visa, MasterCard and American Express do not permit debit or credit card transactions by state legal cannabis businesses.¹⁵³ As a result, retail cannabis businesses cannot

¹⁵⁰ The Federal Reserve's Operating Circular 1 governs account relationships and sets forth the terms under which a financial institution may open, maintain, and terminate a master account. Federal Reserve, Operating Circular 1 (effective Feb. 1, 2013). A "Financial Institution" is defined to include, among other entities, a "depository institution" as defined under section 19(b)(1)(A) of the Federal Reserve Act. That definition of "depository institution" includes any bank that is eligible to make an application to become an insured bank under section 5 of the Federal Deposit Insurance Act. 12 U.S.C. § 461(b)(1)(A). This would include any bank, banking association, trust company, or other depository institution that is both (i) engaged in the business of receiving deposits (other than trust funds), and (ii) incorporated under the laws of any state. See 12 U.S.C. § 1813(a)(2), 1815(a). A public bank that takes deposits and is organized as a corporation under California law, regardless of whether or not its deposits were insured by the FDIC or otherwise, should be able to qualify as a Financial Institution for purposes of Operating Circular 1.

¹⁵¹ The Federal Reserve Board filed an amicus brief in support of the Federal Reserve Bank of Kansas City's position that the Reserve Bank had discretion to deny the master account.

¹⁵² For those who would like a deeper dive into the technical argument, it may be found here, *Fourth Corner Credit Union v. Fed. Reserve Bank of Kansas City*, No. 16-1016, at *19 (10th Cir. June 27, 2017).

¹⁵³ Elain Pofeldt, *Marijuana businesses find card processing still elusive*, CreditCards.com, (January 19, 2016), <http://www.creditcards.com/credit-card-news/marijuana-business-card-processing-elusive-1264.php>. The FDIC has also become increasingly concerned in recent years about reputational risk posed by and to banks,

directly accept debit and credit cards at the point of sale and no sponsoring bank will knowingly process a credit card transaction for a cannabis business. These restrictions have led to a practice of placing a stand-alone third-party vendor ATM in the retail outlet with a security guard to allow cash purchases and avoid the use of credit cards.¹⁵⁴ Despite these restrictions, based on assertions on websites, some cannabis businesses apparently manage to take credit cards.

4. Is there a viable argument under the Tenth Amendment to the U.S. Constitution that the provision of banking services by a public bank to state legal cannabis businesses is protected and that federal law would not apply?

Some cannabis sector advocates have suggested that the Tenth Amendment to the U.S. Constitution may provide a constitutional shield against certain types of federal regulation of a public bank that would operate under the Traditional Plus Cannabis Business Model. The Tenth Amendment provides in relevant part that “the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.”¹⁵⁵ Historically, the Supreme Court has interpreted the Tenth Amendment as evidence of a limiting principle in our constitutional system that prevents the federal government from encroaching on the rightful domain of state government.¹⁵⁶ In the context of public banking for cannabis businesses, a Tenth Amendment issue may arise as a result of the particular method of regulation the federal government seeks to use to implement federal law—the Supreme Court has held that certain methods for implementing regulation violate principles of federalism protected by the Tenth Amendment.¹⁵⁷ Some have also suggested that a Tenth Amendment issue might arise as a result of the application of laws that are generally applicable to private parties to a public bank.¹⁵⁸

Under applicable Supreme Court precedents, we do not believe that the Tenth Amendment would shield state-run businesses or institutions from the dictates of otherwise constitutional federal legislation, even if those organizations engage in activities that are integral or necessary to traditional state government functions. The Supreme Court firmly established in *Garcia v. San Antonio Metropolitan Transit Authority* that Congress has the

specifically in connection with third-party payment processors, and has explained that in conducting due diligence of third-party payment processors, financial institutions must “assure themselves that they are not facilitating fraudulent or other illegal activity.” FDIC, Financial Institution Letter No. 43-2013, FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities (Sept. 27, 2013), http://c.yimcdn.com/sites/www.onlinelendersalliance.org/resource/resmgr/fdic_letter_-_banks_can_proc.pdf.

¹⁵⁴ There are concerns about the unregulated nature of many of these third-party ATM networks leading some in the cannabis sector to decline the ATM in the store model.

¹⁵⁵ U.S. Const. amend. X.

¹⁵⁶ See, e.g., *U.S. v. Darby*, 312 U.S. 100, 124 (1941); *New York v. U.S.*, 505 U.S. 144, 156–57 (1992).

¹⁵⁷ See generally *Printz v. U.S.*, 521 U.S. 898 (1997).

¹⁵⁸ See *National League of Cities v. Usery*, 426 U.S. 833 (1976) (holding that the federal government may not impinge on state functions integral to state sovereignty); *But see Garcia v. San Antonio Met. Transit Auth.*, 469 U.S. 528 (1985) (overruling *National League of Cities* and holding that generally applicable laws apply to state-run organizations with equal force).

authority under the Commerce Clause to subject a state-run business to the same legislation applicable to private parties.¹⁵⁹ The holding and reasoning in *Garcia* would apply to otherwise constitutional legislation regulating the activities of a public bank with equal force. Framing the bank as a “public financial utility” would not change the analysis, as the Supreme Court was firm in *Garcia* that the Court would not distinguish between different types of state activities based on whether or not the activities were “integral” or “necessary” to state governmental functions or whether or not the state government functions were “traditional” in determining whether federal law would apply.¹⁶⁰ The Court strongly suggested that the only constitutional remedy for otherwise constitutional federal regulation of state-run businesses is through the “internal safeguards” of “state participation in federal government action. The political process ensures that laws that unduly burden the States will not be promulgated.”¹⁶¹

Arguments that a public bank will animate policy considerations raised in *Printz v. U.S.* or *New York v. U.S.* are similarly unavailing. These cases establish the Supreme Court’s “anti-commandeering” doctrine, which prohibits Congress from compelling the executive officers or legislative representatives of a state to implement a federal regulatory program.¹⁶² A public bank would not invoke the anti-commandeering doctrine, as a public bank would not be asked to *implement* a federal regulatory program, and the Controlled Substances Act does not involve directives emanating from Congress to state officials. Instead, a public bank would be subject to the federal laws generally applicable to private parties. For example, action by a Federal Reserve Bank that denies a master account to a public bank with the Traditional Plus Cannabis Business Model would not constitute *implementation* of the Controlled Substances Act but *application* of the statute.

Based on the foregoing, we are of the view that the Tenth Amendment would not provide any special protections against the enforcement of otherwise constitutional federal laws regulating the cannabis-related activities of a public bank pursuant to the Traditional Public Bank Business Model. With respect to a public bank established pursuant to the Traditional Plus Cannabis Business Model, because the Tenth Amendment of the U.S. Constitution does not shield state-run businesses or institutions from federal regulation, even if those organizations perform activities that are “integral” or “necessary” to the “traditional” functions of state government, there is no viable constitutional argument that otherwise constitutional federal laws criminalizing cannabis would be overridden by the Tenth Amendment. Framing the bank as a “public financial utility,” as some policy advocates have done,¹⁶³ would not change the analysis.

5. What legislation at the state or federal level would provide clearer solutions?

¹⁵⁹ *Garcia v. San Antonio Metro. Transit Auth.*, 569 U.S. 528, 546–47 (1985).

¹⁶⁰ *Id.* at 546–47.

¹⁶¹ *Id.* at 556–57.

¹⁶² See *Printz v. U.S.*, 521 U.S. 898, 925 (1997); *New York v. U.S.*, 505 U.S. 144, 177 (1992); see also Stannard (claiming that an action against the Federal Reserve “could be buttressed by a Tenth amendment-oriented argument” raising the same points motivating the court in *New York v. U.S.*).

¹⁶³ Matt Stannard, *Public Banking, Including the Banking of State Cannabis Revenue: Federal, California, and Local Legal Considerations*, Commonomics USA (Jan. 10, 2017).

The most definitive action that could alleviate many of the concerns addressed above would be to decriminalize cannabis at the federal level and to bring the entire cannabis business sector into a fully legal and tightly regulated framework.¹⁶⁴ These sentiments are shared by California State Treasurer Chiang, who stated that it has “became apparent that a definitive solution to the cannabis banking quandary will remain elusive until the federal government removes cannabis from its official list of dangerous drugs or Congress approves safe harbor legislation protecting financial institutions that serve cannabis businesses from federal penalties,” and that “there is no durable, failsafe solution to the banking problem until federal law is changed”¹⁶⁵

Although certain federal agencies have developed guidance to address the need for banking services in the state legal cannabis sector, the guidance did not nullify the Controlled Substances Act or federal money-laundering statutes and so does not change the fact that cannabis activities and businesses remain criminal under federal law. The success of any endeavor to provide financial services for the state legal cannabis sector will be impacted by any drug policy and enforcement decisions by the Trump Administration. If the decriminalization of cannabis is not feasible in the short term, the SAFE Act provides the next best alternative for cannabis businesses to obtain access to banking services.¹⁶⁶ While not a perfect solution, the SAFE Act would provide a more feasible alternative than the Cole Memo and the FinCEN Guidance.

III. Possible Next Steps

Given the difficulties in establishing and operating a public bank with a possible Commercial Bank Charter or Credit Union Charter under California law, whether pursuant to either the Traditional Public Bank Business Model or the Traditional Plus Cannabis Business Model, possible next steps would be:

1. Support efforts to decriminalize recreational and medical cannabis use by removing it from the list of Schedule 1 drugs under the Controlled Substances Act. Assist in the implementation of the recommendation from the Chiang Report to establish a multistate consortium of cannabis legal states, local governments, cannabis and financial services industries and law enforcement to pursue other potential changes to federal law that would remove the

¹⁶⁴ Even aside from banking services, it is clear that a legal cannabis business would need to be subject to significant regulation in other aspects as well. For a discussion of what a regulatory situation might look like, see *NACB Guiding Document*, National Association of Cannabis Businesses, <https://nacb.com/> (NACB is the cannabis sector’s first self-regulatory organization).

¹⁶⁵ State Treasurer’s Cannabis Banking Working Group, *Banking Access Strategies for Cannabis-Related Businesses*, 2 (2017).

¹⁶⁶ Alternative legislative solutions may also be under discussion. One alternative solution that has been termed “cooperative federalism” by some would be to amend the Controlled Substances Act to provide that states that meet specified criteria, such as those set forth in the Cole Memo, could opt out of the provisions of the Controlled Substances Act relating to cannabis. See, Erwin Chemerinsky, Jolene Forman, Allen Hopper and Sam Kamin, *Cooperative Federalism and Marijuana Regulation*, 65 *UCLA L. Rev.* 74 (2015). Because this solution is not specific to banking and financial services, it could in many aspects potentially provide broader relief than the SAFE Act, but it may also be less likely to receive the political support necessary to be approved by Congress and signed into law.

barriers to cannabis banking. In our view, only a significant change in federal law will provide a stable platform for the Traditional Plus Cannabis Business Model. We are aware that changes and pressure brought at the state level, such as the possible passage of a public bank statute or the use of a state credit union charter with private insurance, might focus Congress on the need to provide a more stable solution for banking state legal cannabis businesses, but we view federal action as being essential.

2. As a next best alternative to removing cannabis from the list of Schedule 1 drugs, support the passage of the SAFE Act. It would also make sense to advocate for amending the text of the SAFE Act to address directly providing charters, federal deposit insurance or master accounts to *de novo* banks and credit unions in order to remove any ambiguity. The Respect State Marijuana Laws Act of 2017 is another potential solution, but providing an explicit safe harbor in the Act for financial institutions should be considered.
3. Assist in the development of the feasibility study of a public bank owned by the state, as recommended by the Chiang Report, and work with the California Department of Business Oversight, the John Chiang Cannabis Banking Working Group and certain other parties referenced in the Chiang Report, such as the California Department of Justice and Office of the Attorney General, to encourage the California legislature to pass a special statute that would establish a Public Bank Charter that would not need federal deposit insurance and could tailor its business plan, governance models, source of strength obligations and standards for affiliate transactions to its public sector shareholders and the policy goals of the model. We believe it would be useful to enlist the support of private banks in California.
4. Consult with the California Department of Business Oversight to pre-vet the possible use of a Commercial Bank Charter or Credit Union Charter and discuss whether the use of private deposit insurance is a viable option. It may be advisable to seek a written opinion from the California Department of Business Oversight on some points.
5. Consult with the FDIC about the circumstances under which it would provide federal deposit insurance to a public bank with the Traditional Public Bank Business Model.
6. Assist in the other recommendations from the Chiang Report to develop a data portal of compliance and regulatory data for financial institutions that provide services to state legal cannabis businesses and to consider safer, more effective ways to handle the payment of taxes and fees in cash.

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