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On the road to normalization in the emerging market of cannabis financial services, there is a flood of information, but a desert of facts…

CANNABIS FINANCIAL SERVICES:
OPPORTUNITIES AND CHALLENGES

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Context

Legal cannabis is a fast growing, cash based emerging market, hobbled by a lack of normalized financial services, facts, and data. As with many emerging markets, there is a flood of information, but a desert of facts.

With few facts and data available in this industry as there are with other business segments, it's difficult for financial services firms to scope market entry opportunity and risks, and for lawmakers (federal/state/local/tax) to create fair, prudent, workable rules.

As of the publication date of this paper, February of 2021, the U.S. is still in a pandemic, with the government creating large (previously unbudgeted) programs of subsidies and safety. These $2 trillion+ in expenditures are creating devastating budget holes – at the local, state, and federal levels – that could be at least partially filled with revenues from fair taxation on transparent sales of legal cannabis.

Under current tax laws, the US effective tax rate for legal cannabis businesses is up to 90%.[1] This drives up the costs of

legal sales, and the demand for grey market which many say equals or exceeds legal sales, even in the largest, longest legal states. The estimates of potential US tax revenues of legal cannabis sales were approximately $11.9 billion[2] in state and local excise and sales taxes. This paper is not seeking to get into the tax debate, but rather point out that normalized banking, including all electronic payments, could enable full transparency in legal sales, and fuel prudent, well-planned legalization and taxation. This transparency and tax revenues could help address the growing government budget crisis and deter grey market sales.

This paper was commissioned by Emerging Markets Coalition – a young not-for-profit focused on normalizing financial services in underserved markets and is currently targeting cannabis. EMC members are market leaders and market makers in both the cannabis and financial services industries. We drive open, fact-based discussions with government, media, and civic groups, towards making all cannabis transactions transparent, traceable, and fairly taxable.

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[1] https://qz.com/1595906/how-much-tax-do-marijuana-businesses-pay/
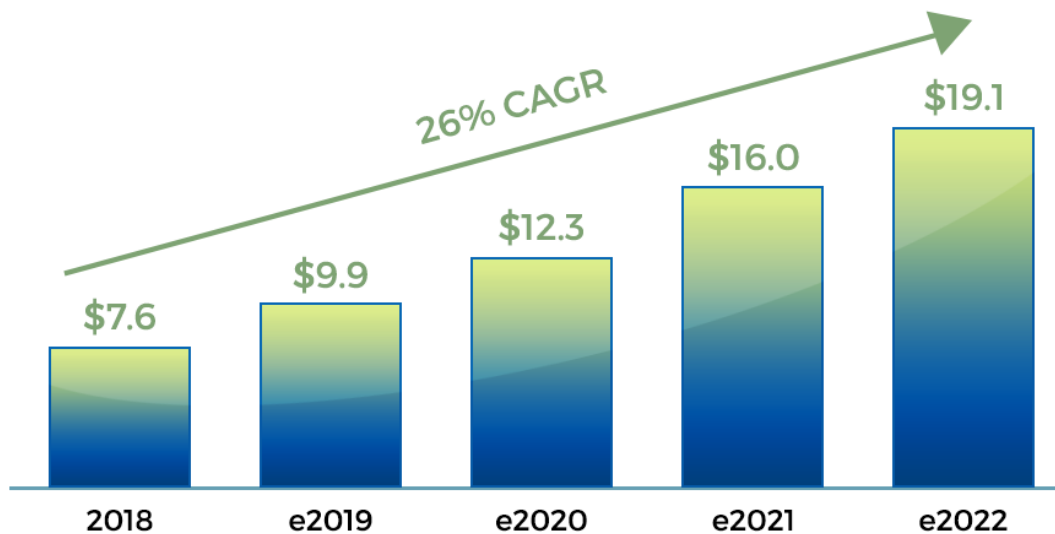[2] https://itep.org/taxing-cannabis

Preview

Financial services firms[3] seeking to drive profitable growth in new emerging markets often look outside US borders, but there is an emerging market in the US with dramatic growth and revenue potential – legal cannabis. However, currently it can carry with it a stigma at the federal and some state levels that is a critical consideration to financial services providers (FS – banking, payments, insurance, lending, investing, payroll, loyalty, etc.). This paper is bringing in voices of both financial services and cannabis-related markets[4] industry

leaders. The paper's goals include a high-level scoping of the opportunity – from both financial services and cannabis industry voices. This scoping includes risk/reward considerations and recommendations on next steps for industry players to evaluate, connect, and collaborate to help drive a normalized financial ecosystem with a broad base of financial services for the cannabis (and related) industries.

Note: Given that there is a dearth of data in this space, citation dates and fact/figures reflect this.

Figure 1: Cash Spending Will Reach US$19 Billion by 2022

Value of Cash in U.S. Dispensary Market, 2018 to e2022 (In US$ billions)

Source: Aite Group

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[3] Financial services include: FinServ, FinTech, traditional banking, payment, capital markets, investments, lending, insurance, payroll, loyalty, accounting/tax

[4] Cannabis-related industries include: cannabis, hemp, CBD, and ancillary industries serving them

Authors:

Please see the end note for more information. This paper was co-authored by those listed, with input from many other experts across the financial services, FinTech, government, tax, law enforcement, academia and cannabis-related industries.

The Cannabis Industry

Please see page 14 for a detailed cannabis overview. These legal businesses require the same array of financial services as do other market sectors, but often have little or no access to the same broad range of financial services. Even in the states where cannabis has been legal for several years, there is still often a limited number of full-service financial providers offering a full range of services to this legal market.

OPPORTUNITIES in this Financial Services Emerging Market

Pundits predict that once legislation passes to clear the way for federal banking, there will be an explosion of FS offerings for the 30,000+ firms in and related to the legal US cannabis industry, and that hundreds of banking, investment, and insurance providers will bring offerings to market quickly.

But that's not entirely accurate. Cannabis,

even when fully legal, will still be a "high risk" market to bankers – similar to alcohol and liquor – and that is not likely to change. In recent EMC meetings with some of the largest traditional financial services providers, several have predicted dramatic growth and see this multifaceted industry *as one of the largest emerging green field opportunities in decades.*

An emerging market of 30k businesses and over 250k[5] employees – provides a green field market for financial services firms serving businesses - most needing access to a broad range of financial services in a highly cash based and fast-growing market. Plus, the payments related to a legal market are estimated at >$23B/yr.[6] in retail sales.

Cannabis Markets – US and International

As of the publishing of this paper, Medical and/or Adult-Use Cannabis has been legalized in 46 countries.[7, 8] Legislation has been passed in 45 US states, Washington DC, and 4 US Territories - with many others pending legislation and ballot initiatives - for Medical Cannabis, Adult-Use Cannabis, Medical CBD and Hemp. There are estimated to be over 7,500 dispensaries in the US, a number expected to rapidly grow.[9]

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[5] https://internationalcbc.com/how-many-people-work-in-the-legal-u-s-cannabis-industry
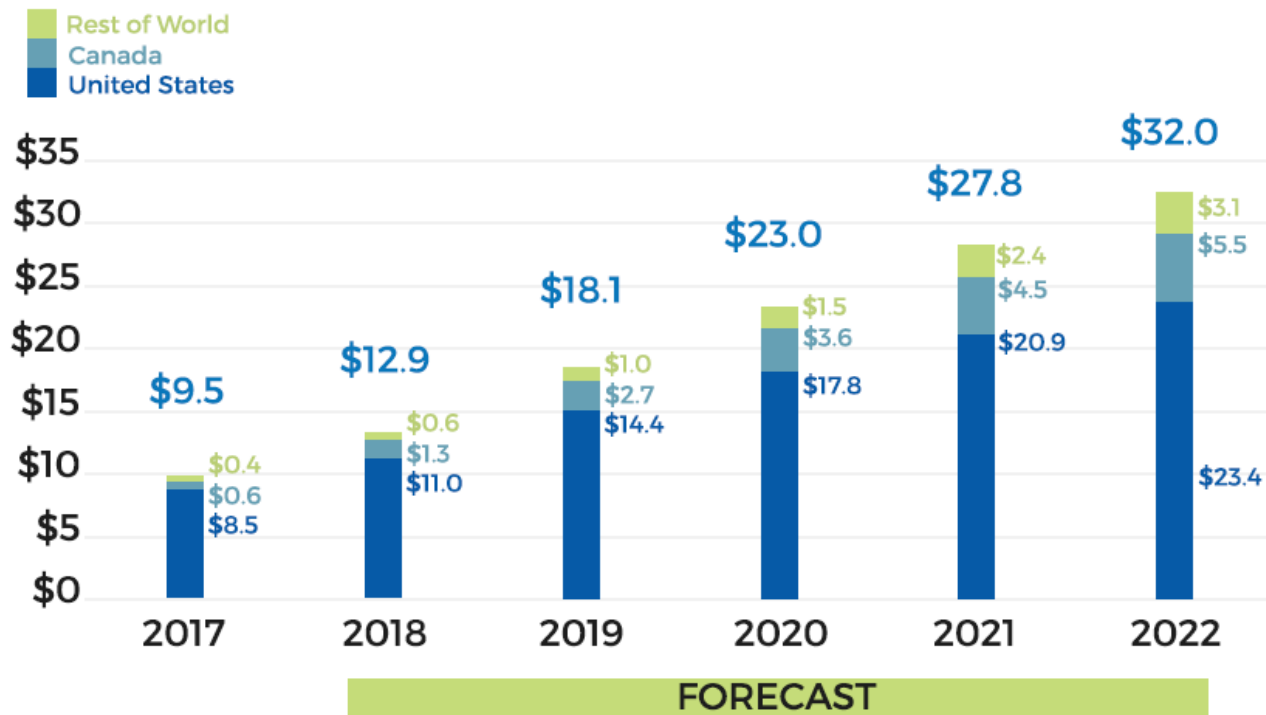[6] https://mjbizdaily.com/exclusive-us-retail-marijuana-sales-on-pace-to-rise-35-in-2019-and-near-30-billion-by 2023/
[7] https://en.wikipedia.org/wiki/Legality_of_cannabis
[8] https://www.fool.com/investing/stock-market/market-sectors/healthcare/marijuana-stocks/
[9] https://disa.com/map-of-marijuana-legality-by-state

According to Arcview Market Research the worldwide legal cannabis industry generated an estimated $14.9 billion in 2019, up 45.7% from 2018, which had seen just 17% growth to $10.2 billion. An examination of the economic multiplier effects through which US consumer spending on legal cannabis in 2021 of $20.8 billion will generate $39.6 billion in overall economic impact, 414,000 jobs, and more than $4 billion in tax receipts. US forecasted sales are $21B by 2023 with a CAGR of over 25% *without including easing of federal legislation.*

Figure 2: Legal Cannabis Spending (In Billions)

Source: Arcview Market Research/BDS Analytics

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Emerging Markets - US States

From the 2020 ballot initiatives, five more states have legalized medical or recreational, adult-use cannabis beginning in 2021 - Arizona, Mississippi, Montana, New Jersey, and South Dakota. These new markets will impact the landscape of employment, payroll, and revenue tax. News reports indicate that the tide of legalization will not slow down. It is reasonable to assume the trend will continue and the need for banking and financial solutions will increase exponentially.

For 2021, 11 more states are expected to consider the legality of recreational marijuana – including Connecticut, Delaware, Maryland, Minnesota, New Mexico, New York, Pennsylvania, Rhode Island, Texas, and Wisconsin.[10] The states of Alabama, Kentucky, and South Carolina could legalize medical marijuana this year as well.[10]

Cannabis Tax and Payroll Forecasts

Data informing these projections is examined using a specialized model developed for EMC that analyzes current industry information from both a state-by-state and overall national perspective. Considering data in the arenas of industry growth, revenue and market potential, and employment, EMC will continue to expand the model as more states move into the legal cannabis arena. It will be used as a resource to inform and lead the discussion on what can be expected in these new markets in terms of industry size and growth rate, employment opportunities, and revenue from payroll and taxation - topics which EMC will dive deeper into in upcoming publications as we also explore what tools and services are needed to support this unstoppable industry.

[10] https://cannabiz.media/states-that-could-legalize-cannabis-in-2021/

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Financial Services

Payments: With such rapid market growth projections, there are attendant risks. The classification of cannabis as a Schedule 1 drug causes particular challenges for federally chartered Financial Institutions. Any highly cash-based market puts businesses at high risk for internal and external theft, robbery, and money laundering - couple this with the fact that the current consumer payment processing offerings are often structured as a work-around vs traditional payment rails. As a federally illegal substance, card networks (AMEX, Discover, MasterCard, Visa) prohibit cannabis transactions on their network. This drives businesses into often opaque solutions - which may be unstable, temporary, and carry additional security and liability issues for the business.

Banking: The breadth of availability of financial services varies among states - largely affected by the perceptions of financial services and civic leaders, and impacted by the status of legalization. Where legalization has existed longer, banking is more readily available (often with fewer services and higher costs than other business sectors). In states that are early in their legalization journey, banking institutions willing to serve cannabis-related businesses are harder to come by. In addition to basic banking and payments, other high-quality critical business services such as loyalty, lending, investments, insurance, accounting, legal, media/PR, HR/benefits, and payroll are minimally available to cannabis businesses. Owners and leaders in the cannabis-related industries are also asking for a better understanding of how to best discern between strong legitimate financial services providers, and the array of what one long-time dispensary owner called "charlatans - preying on this market".

Lawmaking: Solutions are continually emerging as regulators and lawmakers work on clarifications to enable safe, transparent, normalized financial services for this market. If/when cannabis is removed from Schedule 1, it's predicted to have a significant impact towards availability of financial services. There are also several State and Federal bills proposed – directly in financial services, and in tangential areas that will affect this sector. For example, the Secure and Fair Enforcement (SAFE) Banking Act of 2019, which passed the House of Representatives at the end of September 2019 is actively seeking "To create protections for depository institutions that provide financial services to cannabis-related legitimate businesses and service providers for such businesses, and for other purposes." The federal bills pending have a good start, but don't solve the challenge of Schedule 1 for federal payment networks and banks. These rules need to provide clarification to truly address the needs of this market and of

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those who seek to serve it with transparency, security, and quality - and build the barriers to help address and reduce illicit activity.

Best practices: In more developed financial services markets, industry leaders collaborate to establish best practices. These are developed by the industry, to help set structure and clarity - for those serving the market, lawmakers and regulators, and for the industry itself to be able to identify the good financial services providers from the bad. EMC's founders and Board have successes in these efforts for other highly regulated high cash industries and seek to deliver the same here.

Challenges: Taxation

Cannabis market leaders seek to establish fair federal tax laws for their legal businesses. They may be taxed higher than normal consumption businesses like coffee shops, but less than what applies now under IRS 280E. There are indeed benefits to the federal tax coffers if this can be established. If full legalization occurred in all 50 states today, there would be in excess of 654,000 new jobs, increasing to 1 million jobs by 2025.[11] Full legalization would result in more legal businesses entering the market, fewer consumers participating in the grey market, and more employees on official payrolls, and

$3.3 billion in payroll taxes, with an expected increase to $5.3 billion by 2025. Assuming the federal government would impose a 15 percent sales tax on cannabis sales, the study estimates that marijuana businesses will remit $46 billion in sales taxes and $54.3 billion in business taxes in 2025, for a total of $105.6 billion." [11]

One scenario: Assuming a sales tax at the federal level was implemented at 15%, the total tax revenues from 2017–2025 would theoretically be $46 billion - entirely new revenue to the U.S. Treasury, as there are currently no federal sales or excise taxes. By combining the business tax revenues, the payroll withholdings, and a 15% retail sales tax, the total federal tax revenue potential of legalization is estimated to be $105.6 billion.[11] The difference between the current taxation structure and the theoretical model is a USD $61.6 billion increase in federal tax revenues.

> In 2018, it was estimated that if full legalization occurred in all 50 states there would be in excess of *654,000 new jobs, increasing to 1 million jobs by 2025*[7]*... One scenario… the total federal tax revenue potential of legalization is estimated to be $105.6 billion.*[11]

[11] https://newfrontierdata.com/cannabis-insights/cannabis-taxes-generate-106-billion-create-1-million-jobs-2025/

Legacy Cash Estimations

With the historic cash-based business, many operators are dealing with "legacy cash" that was generated either before they were licensed or before they had a bank account. Just one example, shared by an EMC member, is a story of a California dispensary with 2 locations and $80mil in legacy cash that the owner said no bank would accept, even though his business itself is now fully banked. Banks do not want to accept cash for which there's no paper trail, thus cannabis businesses may find themselves in a dangerous security position. Currently, since there is no specific tax amnesty for those failing to report cannabis income, the IRS relies on voluntary disclosure resulting in potential non-compliance and missed tax revenues.

Miscalculation of banks proactively serving the cannabis-related industries:
While many have interpreted the FinCEN (Financial Crimes Enforcement Network) report to say that there are over 300 banks in this space, this is not what their reported number means. The FinCEN number is how many banks file Suspicious Activity Reports (SARS). This means any transaction that fits a SARS trigger is reported by the bank who spotted it. This does not mean that the bank is actively serving this market.

Illicit Market Considerations

States' legalization foibles are creating their own incentives to drive illicit markets

Even in states where both medical use and adult use are legal, the divide between state legalization and city and county municipalities means cannabis has become easily accessible where it is permitted, but the rest of the state may be left with "cannabis deserts" where the grey market can thrive. In addition, high tax rates, licensing fees, and operating costs of keeping up with ever-changing regulations all drive up the cost of legal cannabis. In some parts of California, taxes can account for up to 45%[12] of the purchase price of legal cannabis, *leading 1 in 5 consumers to report they have continued purchasing at least some of their product, from the black market.[13]* In 2018, before adult use, California consumers spent $500 million less than they did in 2017. That meant California came up more than $100 million short of its expected tax revenue by creating an unaffordable market with poor accessibility which was unable to meet the needs of its consumer base.

It's also a problem in states that just recently lifted prohibitions, because cannabis oversight boards are having trouble designing and implementing workable regulations fast enough, keeping legal supply low and driving consumers to the grey market.

In Massachusetts, 75% of the cannabis sold in 2019 was expected to come from the untaxed, unregulated grey market due to the state's slow pace of licensing cannabis shops. States being able to easily (and confidently) establish and implement regulations and enforcement, in concert with clear federal compliance, is critical to implementable rules to follow – for both businesses and the financial services entities to serve them.[14]

> *In some parts of California, taxes can account for up to 45%[12] of the purchase price of legal cannabis, leading 1 in 5 consumers to report they have continued purchasing at least some of their product, from the black market.[13]*

12 https://www.fool.com/investing/2019/11/24/no-joke-california-will-increase-its-cannabis-tax.aspx
13 https://mjbizdaily.com/consumer-study-nearly-1-in-5-california-consumers-buy-from-black-market/
14 https://www.bostonglobe.com/news/marijuana/2019/02/02/illicit-pot-market-remains-stubbornly-robust/Fqq5baxLvgkrTB1ABJRbEL/story.html

SUMMARY

This fast growing, cash-based emerging market is hobbled by a lack of data and facts. A lack of transparency of transactions and clarity of rules and regulations prevent many financial institutions from serving this market.

With little facts, data, or view into financial transactions, it's very difficult for lawmakers to create prudent workable rules. This is exacerbated by the dearth of accessible high-quality robust financial services for cannabis-related businesses.

EMC is a young not-for-profit serving this market, driving collaborative expertise across the cannabis-related and financial services industries to achieve full and responsible scale and growth potential: driving every dollar to be transparent, traceable, and fairly taxable. Establishment of a framework of standards ensures that financial and networks can be built with legally compliant, transparent cannabis business operations. Industry best practices and transparent electronic transactions will also enable collection of reliable data, which can be mined and analyzed to create real-time informative summary data to scope, forecast, and plan for growth and risk.

CALL TO ACTION

To grow and gain access to a full range of normalized and innovative financial services, this industry needs facts, data, clarity, and transparency. EMC partners with researchers, government, academia, and data-driven solution providers to help fuel the drive for fact-based information – to feed the market, investors, media and government.

For this paper, EMC collaborated with Cann Do, LLC. Their proven "Seed to CPA" methodology uses best business practices and transparency for every plant, gram, and penny - enabling real-time accurate and reliable data – providing information and security needed to support a highly competitive, richly featured, normalized cannabis financial services marketplace.

Please consider joining EMC in driving this critical work – bringing accuracy and transparency to an opaque market and opening the minds of many who, if well informed, can enable the broadening to a larger legal market served with a full menu of financial services.

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Authors

This paper's authors have helped businesses scope their opportunity in this market by applying the above to their own piece(s) of the value chain they serve, and applying them to our industry models and forecasting tools. The results have generally been dramatic, highlighting an opportunity for marked growth and in many cases, an entirely new market to enter. The growth and profits need to be balanced in a risk/rewards model, so these plans for market entry strategies and expansions always include compliance, risk, and legal inputs. These market plans also often include a proactive visit with clients' regulators to gain their input and perspective up front, and include these in the market planning, partnering, and timing.

Financial Services:

Kirsten Trusko, CEO and Co-Founder of Emerging Markets Coalition
LinkedIn Profile for Kirsten Trusko
Kirsten led organizations and industries to normalize financial services in 3 previously underserved markets. Her history includes roles in FinTech and traditional financial services – with industry, government, and advisory including Transamerica, Case, KPMG

Consulting, and NBPCA.org. She's delivered over 300 speeches, been interviewed 100+ times, testified in Congress and in court cases, and participated in many task forces and working groups to drive high-impact change in underserved and emerging markets.

Cannabis and related ancillary businesses:

Kelly Whyman, Founder of Cann Do, LLC.
LinkedIn Profile for Kelly Whyman
Kelly's company has been guiding Cannabis-Related Businesses through licensing, compliance, development, and implementation of transparent tracking systems for all plants, grams, and money since 2010 using a unique Seed to CPA™ methodology that she developed in order to better serve her clients. She also provides her business expertise in other industries – including liquor, automotive, and agriculture – to establish and maintain transparent best practices. Cann Do creates and implements operational standards, and establishes associated electronic recordkeeping practices using cloud-based software to ensure compliance, as well as accurate inventory and financial reconciliation on a daily basis.

Sarah Londberg, Cannabis Subject Matter Expert/Writer

Sarah is an independent project manager and professional content writer. She has been creating business development strategies, company infrastructure, and standard operating procedures which align to electronic tracking systems to ensure compliance, traceability and transparency in cannabis companies since 2012. Her knowledge and authorship have been essential in the awarding of cultivation, processing, and dispensing licenses nationwide in both medical and adult-use markets. Prior to becoming a consultant, Sarah was an operator in Colorado with both cultivation and dispensary licenses. Her experience with chain of custody, regulatory compliance, process validation, and traceability were established in her previous career in rapid response surgical pathology and Cells, Tissues, and Cellular and Tissue-Based Products (HCT/Ps) recovery, research, and development.

Emerging Markets Coalition (EMC) is a 501c6 not-for-profit coalition focusing on driving normalized financial services for emerging markets. A key current focus is on the cannabis-related markets. EMC brings industry leaders and market makers in both cannabis and financial services together under one tent to educate, advocate, protect, and promote key influencers of the market, including legislators, regulators, legal, media, advocacy, and civic groups. EMC sets the highest bar for Best Practices, especially in regulatory and compliance. We pool our resources and influence to drive transparency and access to a full menu of products and services – banking, payments, loyalty, insurance, legal, accounting, lending, investment, etc.

Cannabis Overview

Cannabis is a genus of plants of which Cannabis Sativa L the cannabis plant produces trichomes during its cultivation lifecycle, which contain unique chemical compounds known as cannabinoids: currently over 100 different cannabinoids have been identified. A handful of cannabinoids, such as THC, CBD, CBG, CBC, and CBN are thought to have psychoactive and/or medicinal effects on the body and endocannabinoid system. Similar to cannabinoids produced from the trichomes from the cannabis plant, terpenes and terpenoids are hydrocarbons, a class of organic compounds which are the primary element in essential oils, perfume and traditional medicines. The unique combination of terpenes and cannabinoids are thought to be responsible for the variety of aromas and effects that differentiate varieties of cannabis from one another.

Cannabis plant fibers, seeds, oils, flowers, and leaves are also used for industrial, medicinal, and recreational purposes. Four distinct global markets have developed from the cultivation, manufacturing, distribution, and sales of the cannabis plant:

1. The Industrial Hemp market as defined by the US classifies hemp as Cannabis Sativa L. that contains no more than 0.3 percent THC (delta-9-tetrahydrocannabinol) on a dry weight basis. Industrial hemp products such as Fiber, which can be used for a variety of commercial products such as paper, clothing, sustainable plastics, paints, building materials, biofuel, food and animal bedding, and feed. Industrial hemp can produce flowers and leaves that produce oils, inhalable, edible, and topical products. Industrial Hemp produces grain and seeds for continued farming, food and nutritional products.[15]

2. Medical CBD in the United States is defined by States that wish to offer an option to patients with approved conditions to use Medical CBD that was produced from Cannabis Sativa L. that contains no more than 0.3 percent THC (delta-9-tetrahydrocannabinol) on a dry weight basis.

3. Medical Cannabis is defined differently by each State and Country, but all are producing products from the Cannabis Sativa L. plant to provide "medicine" to patients with approved medical conditions who seek some relief from their debilitating conditions. Medical Cannabis licenses depending on the Country, State and local government can include activities such as cultivation, manufacturing, laboratory testing, distribution, transport, delivery, and retail sales. Medical Cannabis is administered through a variety of methods such as capsules, dermal patches, edibles, lozenges, sublinguals, oils, oral sprays, smokable dried products, tinctures, and vaporizing.

4. Adult-Use Cannabis is defined differently by each State and Country, but all are producing products from the Cannabis Sativa L. plant to provide cannabis products to adults over the age of 21. Adult-Use Cannabis licenses depending on the Country, State and local government can include activities such as cultivation, manufacturing, laboratory testing, distribution, transport, delivery, retail sales, and hospitality.

[15] https://fas.org/sgp/crs/