Marijuana, Guns, Craft Beer, Wine and Gambling Law: The Ultimate Guide

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Marijuana, Guns, Craft Beer, Wine and Gambling Law: The Ultimate Guide

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Presenters (Cont.)

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Recreational Marijuana Law

Submitted by Jeffrey Gard

RECREATIONAL MARIJUANA LAW

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OVERVIEW

- Federal Responses to Recreational Marijuana Law
- Banking and Financing for the Marijuana Industry
- Recreational Marijuana Business Law
- Obtaining a Cannabis Business License
- Legal Best Practices for Marijuana Product Packaging and Testing
- Marijuana Taxation: the Latest Rules

RECREATIONAL MARIJUANA BUSINESS LAW

33 States and Washington DC allow medical.

10 States and Washington DC allow adult use.

FEDERAL RESPONSES TO RECREATIONAL MARIJUANA LAW

- **Controlled Substances Act**
  - Signed into law in 1970 to be a framework for regulating all drugs.
  - Classifies and regulates drugs from cough syrup to methamphetamine.
  - Gives the Drug enforcement Administration and the Food and Drug Administration the responsibility of classifying drugs.
- **Commerce clause authority**
  - *Gonzales v. Raich:* Marijuana grown in a man's home and consumed locally was found to be interstate commerce.

FEDERAL RESPONSES TO RECREATIONAL MARIJUANA LAW

- Trend of Non-Enforcement: Recent Method of handling the problem.
- August 29, 2013: “Cole Memo” by Obama Administration
  - Prioritizes cartels, drugged driving, black-market marijuana, federal lands, violence, and marijuana to minors.
  - Moving forward, this may be problematic since it does not give any guidance to citizens.

FEDERAL RESPONSES TO RECREATIONAL MARIJUANA LAW

- January 5, 2018: Jeff Sessions published a memo rescinding the Cole Memo.
  - In the memo, Sessions directs all U.S. Attorneys to enforce the laws enacted by Congress, and follow well-established principles when pursuing prosecutions related to marijuana activities.
  - This change leaves state-legal marijuana in a more troublesome position.
- January 15, 2019: In a confirmation hearing, new AG nominee William P. Barr said he would not prosecute the possession and sale of marijuana in states that had legalized it, signaling a return to the Obama-era policy of non-enforcement.
  - However, he may be interested in passing a “federal law that prohibits marijuana everywhere,” but in the meantime will not disrupt states from their expectation of marijuana legality.

BANKING AND FINANCING FOR THE MARIJUANA INDUSTRY

- Money Laundering Control Act:
  - 31 USCA § 5324
  - MLCA prohibits transfer of proceeds related to specified unlawful activities
  - Acts involving dealing in controlled substances are among the specified unlawful activities
  - The transfer of proceeds of which could lead to a charge of money laundering

BANKING AND FINANCING FOR THE MARIJUANA INDUSTRY

- Bank Secrecy Act
  - Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970, U.S.C. 5311, Et. Seq.
  - Requires financial institutions to detect and prevent money laundering through keeping records and fling reports of cash transactions of more than $10,000 and reporting suspicious activity that might form money laundering, tax evasion and criminal activities
  - Prohibits financial institutions from accepting deposits and “failing to identify or report financial transaction involving proceeds of Controlled Substance Act violation”
  - Penalty for willful violations: $25-100k/day

BANKING AND FINANCING FOR THE MARIJUANA INDUSTRY

- February 14th, 2014 – FinCEN Banking Guidance
  - Clarifies how to provide financial services to marijuana-related businesses
  - Outlines due diligence practices to follow to avoid prosecution
  - Red Flags
    - Offshore Accounts
    - Miscoding of Applications
    - Large Cash Deposits
  - Suspicious Activity Report ("SAR")
    - Limited – Priority – Termination

BANKING AND FINANCING FOR THE MARIJUANA INDUSTRY

- What are the Risks?
  - Holding or loss of funds
  - Inability to Open Merchant Account
  - Member Alert to Control High-Risk: Merchants list or Terminated Merchant File credit card program identifying merchants that acquirers have terminated (includes both corporate and owners identity)
  - Fourth Corner Credit Union – Master Account Denial
  - Safe Harbor

BANKING AND FINANCING FOR THE MARIJUANA INDUSTRY

- Current Options:
  - Cash
  - Credit & Debit Cards
  - ATMs, Cashless ATMS, Interbanking
  - Coupons, Vouchers, Checking account schemes

OBTAINING A CANNABIS BUSINESS LICENSE

C.R.S. 12-43.4-401 sets out five main types of licenses:

- Retail Marijuana Store Licenses;
- Retail Marijuana Cultivation Facility Licenses;
- Retail Marijuana Products Manufacturing Licenses;
- Retail Marijuana Testing Facility Licenses; and
- Occupational Licenses for managers, operators, employees, contractors, and other support staff.

OBTAINING A CANNABIS BUSINESS LICENSE

Retail Marijuana Store License

- Issued to people who sell retail marijuana and prepackaged retail marijuana-infused products to adults over 21.
- They may grow their own marijuana at a retail marijuana cultivation facility or buy from other facilities.
- They must get state and local approval before a license will be issued.
- A 15% sales tax, in addition to all standard state and local sales taxes, will be imposed.

OBTAINING A CANNABIS BUSINESS LICENSE

Retail Marijuana Cultivation Facility

- Given to people who wish to grow marijuana for sale to Retail Marijuana Stores, Retail Marijuana Products Manufacturers, or other RMCFs;
- License will regulate how much marijuana can be produced;
- A 15% excise tax for school construction will be imposed on all sales from RMCF's to other businesses; and
- The 15% rate will be determined by the "average market rate" for wholesale marijuana.

OBTAINING A CANNABIS BUSINESS LICENSE

Retail Marijuana Store License:

- Issued to people who sell retail marijuana and pre-packaged retail marijuana-infused products to adults over 21.
- They may grow their own marijuana at a retail marijuana cultivation facility or buy from other facilities.
- They must get state and local approval before a license will be issued.
- A 15% sales tax, in addition to all standard state and local sales taxes, will be imposed.

OBTAINING A CANNABIS BUSINESS LICENSE

Retail Marijuana Cultivation Facility

- Given to people who wish to grow marijuana for sale to Retail Marijuana Stores, Retail Marijuana Products Manufacturers, or other RMCFs;
- May not be held as a stand alone license until September 30, 2014;
- License will regulate how much marijuana can be produced;
- A 15% excise tax for school construction will be imposed on all sales from RMCF's to other businesses; and
- The 15% rate will be determined by the "average market rate" for wholesale marijuana.

OBTAINING A CANNABIS BUSINESS LICENSE

Retail Marijuana Products Manufacturers License

- Issued to people who create retail marijuana infused products such as edibles or hash.
- They may purchase marijuana from Retail Marijuana Cultivation Facilities (RMCF) or grow their own their own.
- 10 milligram serving size for edibles, with a 100 mg cap on THC in one package (lower than most medical marijuana edibles).
- There is no special sales tax imposed on wholesale marijuana products.

LEGAL BEST PRACTICES FOR MARIJUANA PRODUCT PACKAGING AND TESTING

Quality Control and Testing Considerations:

- 7 different types of testing currently being certified by the Colorado Department of Health
  - Residual Solvents;
  - Microbials;
  - Myctotoxins;
  - Pesticides;
  - THC and other Cannabinoid potency

LEGAL BEST PRACTICES FOR MARIJUANA PRODUCT PACKAGING AND TESTING

Mandatory Contaminant Testing Program

- MIPS and Cultivation Facilities must become "validated"
  - Cultivation facilities get 12 separate tests over 12 week period for microbials, mold, filth, and residual solvents
  - MIPS submit every production batch for 4 week period for same tests
  - Validation stays unless recipe change or use of different chemicals in grow process
  - MED may require additional testing at any time for any reason
  - All MIPS and Cultivation facilities must get 10% of their batches tested every year

MARIJUANA TAXATION: THE LATEST RULES

Authority to Tax:

- "The power to tax income like that of the new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed."
  - New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934)
- Constitutional Issues:
  - 16th Amendment allows taxation of income
    - For retailer or producer, income is gain on sale (gross receipts – COGS), not Gross Receipts

MARIJUANA TAXATION: THE LATEST RULES

Tax for Marijuana Businesses

- What are costs of goods sold:
- COGS "… embraces expenditures necessary to acquire, construct or extract a physical product which is to be sold; the seller can have no gain until he recovers the economic investment that he has made directly in the actual item sold." *Reading v. Commissioner,* 70 T.C. 730, 733 (1978).
- The formula for determining COGS is:
  - Beginning inventory

  + current-year production costs (producer)

  + current-year purchases (reseller)

  - Ending inventory

MARIJUANA TAXATION: THE LATEST RULES

Internal Revenue Code 280E

- In 1982, Congress enacted what would become IRC Sec. 280E, which states:
- Language: "No deduction … shall be allowed for any amount paid… in carrying on any trade or business if such business.. Consists of trafficking in controlled substances…"
- Impact: Disallows ordinary and necessary business expenses related to sale of cannabis.

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Medical Marijuana Law

Submitted by Jeffrey Gard

MEDICINAL MARIJUANA DISPENSARY LICENSING AND PROCEDURES

OVERVIEW

- Federal Responses to Medical Marijuana Laws
- Obtaining Medical Marijuana Business Licenses: Overcoming Hurdles
- Essential Business Considerations for Medical Marijuana Dispensaries
- Financing Difficulties for Lenders and Marijuana Businesses
- Medical Marijuana Business Taxation: Strategies to Overcome Current Difficulties
- Patients, Caregivers and Physicians: Ensuring Legal Compliance
- Contracts for Cannabusinesses

FEDERAL RESPONSES TO MARIJUANA LAWS

- Marijuana is still illegal federally, but is legal in a growing number of states.
- State laws conflicting with federal law are generally preempted and void (U.S. Const., art. VI, cl. 2, *Wickard v. Filburn,* 317 U.S. 111, 124 (1942)
- "No form of state activity can constitutionally thwart the regulatory power granted by the commerce clause to Congress." *United States v. Wrightwood Dairy Co.*, 315 U.S. 110, 119 (1942)

FEDERAL RESPONSES TO MEDICAL MARIJUANA LAWS

- Trend of Non-Enforcement is the recent method of handling the problem
- August 29, 2013: "Cole Memo"
  - Prioritizes cartels, drugged driving, black-market marijuana, federal lands, violence, and marijuana to minors.
  - Moving forward, this may be problematic since it does not give any guidance to citizens.
- January 5, 2018: Jeff Sessions published a memo rescinding the Cole Memo. This change leaves state-legal marijuana in a more troublesome position. It is not clear yet what action will be taken by federal law enforcement.

OBTAINING MEDICAL MARIJUANA BUSINESS LICENSES: OVERCOMING HURDLES

C.R.S. 12-43.3-401 sets out four main types of licenses:

- Medical Marijuana Center Licenses;
- Optional Premises Cultivation Licenses;
- Medical Marijuana-infused Products Manufacturing Licenses; and
- Occupational Licenses for managers, operators, employees, contractors, and other support staff.
- There are also "vendor" licenses which are not specifically authorized by statute.

MEDICAL MARIJUANA BUSINESS LICENSES (CONT.)

Medical Marijuana Center License

- Issued to people who sell medical marijuana and medical marijuana-infused products to registered patients
- They must grow their own marijuana at an optional premises cultivation facility
- They may purchase up to 30% of their inventory from other MMCs
- Only regular sales tax applies
- Patients may register one MMC as their "primary center" which allows the center to grow plants on their behalf
    - This normally gets the patient discounts or other "member specials"

MEDICAL MARIJUANA BUSINESS LICENSES (CONT.)

Optional Premises Cultivation Facility License

- Must be connected (not physically) with a licensed MMC
  - The MMC is the main business and the OPC is part of that business
- May grow up to 6 plants for every patient that selects the MMC as their primary center
- May do no wholesaling of any kind
  - Wholesaling may only take place through the MMC subject to the 70-30 rule
- There is no excise tax on medical marijuana cultivation

MEDICAL MARIJUANA BUSINESS LICENSES (CONT.)

Infused Products Manufacturers License

- Issued to people who create medical marijuana-infused products such as edibles or hash.
- May have an associated OPC to grow their own marijuana to make products
- May contract with MMC's to take marijuana from the MMC, produce a product, and give the product back to the MMC for a fee
- No more than 5 MMC's marijuana may go into a single product

MEDICAL MARIJUANA BUSINESS LICENSES (CONT.)

- The State is now accepting applications for all medical marijuana businesses.
  - Only big difference between retail and medical applications is the necessity of having an OPC.
- Local governments have a wide range of regulations that may or may not allow you to apply.
- State application is turned in first and they forward part of application fee to local government.
- Local government is normally a more involved process with zoning, building, fire, and police inspection.
  - Really depends on the local government. Some jurisdictions are stricter than others.

MEDICAL MARIJUANA BUSINESS LICENSES (CONT.)

- 1 CCR 212-1, M 231
- (1) paid the application/licensing fees
- (2) criminal history indicates “Good Moral Character”
- (4) at least 21 years old
- (6) no felonies in the five years preceding application
- (8) no felonies for using a controlled substance in the 10 years preceding application
- (10) no law enforcement officials

MEDICAL MARIJUANA BUSINESS LICENSES (CONT.)

- Anyone with a financial interest in a retail marijuana business must have been a CO resident for at least one year prior to the application
- All employees must be CO residents with no time requirements
- To determine residency look to “primary home”
- Also look at employment, businesses, income sources, residence for taxes, age, spouse and children, leases, motor vehicle registration, and voter registration
- The Totality of the Evidence Standard is used.

MEDICAL MARIJUANA BUSINESS LICENSES (CONT.)

- You do not need to be a Colorado resident to own or have a financial interest in marijuana business.
- Publicly traded entities can hold a marijuana license.
- Anyone intending to apply to become a controlling beneficial owner or passive beneficial owner must receive a finding of suitability or exemption from state licensing authority before submitting an application.
- New bill limits types of publicly traded corporations that can be marijuana businesses or controlling beneficial owners.

ESSENTIAL BUSINESS CONSIDERATIONS FOR MEDICAL MARIJUANA DISPENSARIES

- Biggest issue for medical businesses is the 50/50 rule.
- Vertical integration
  - Shotgun marriages of sellers and growers
- Uncertainty in the medical market
  - Chronic pain reform
  - Caregiver reform

FINANCING DIFFICULTIES FOR LENDERS AND MARIJUANA BUSINESSES

- Banking is a consistent problem for marijuana entities
- Four current credit unions in Colorado for the marijuana industry in Colorado
  - Tend to have high fees and require at least two bank accounts
  - No guarantee the account will not eventually be closed at the credit unions request

  Lending
  - No lending
  - No Standard type accounts

MEDICAL MARIJUANA BUSINESS TAXATION: STRATEGIES TO OVERCOME CURRENT DIFFICULTIES

Bookkeeping Tips:

1. Hire a good tax lawyer/accountant
2. Have a good cost-accounting system
3. Have a good inventory system
4. Keep, file, and organize receipts
5. Prepare monthly financial statements
6. Engage in 1 or more trades/businesses that don't involve marijuana
7. Remember factors when operating more than one business

MEDICAL MARIJUANA BUSINESS TAXATION: STRATEGIES TO OVERCOME CURRENT DIFFICULTIES

- Hire a bookkeeper and CPA with prior experience in manufacturing or farming.
  - Section 471 requires inventory accounting, which these industries have been using for years
- Whenever allocating General and Administrative expenses to COGS, document the method and justification for the allocation and keep them with the accounting/tax records for the company
- To the extent that you can separate expenses between grow and retail, do so. For instance, if you can separately meter for utilities the grow space and retail space, you will avoid arguments about the proper allocation of utilities
- Invest in a good POS system that will track exactly what was sold, and when.
- Be prepared the IRS will be looking for an indirect method of proof for gross receipts (because of the cash-based nature of the business). For this, keep good records of all grow operations, including total plants started, per plant yield, wet and dry weight, waste, etc. Colorado's required METRC system does an excellent job with this. Since its introduction, questions about gross receipts in IRS audits have been significantly reduced.

MEDICAL MARIJUANA BUSINESS TAXATION: STRATEGIES TO OVERCOME CURRENT DIFFICULTIES

- If you receive an audit letter:
  - Get experienced help immediately
  - Do not respond to letter
  - IRS agents are well trained
  - Potential exists for criminal investigations and charges
  - Who should handle audit: lawyer or accountant?

PATIENTS, CAREGIVERS AND PHYSICIANS: ENSURING LEGAL COMPLIANCE

- Patients see a doctor to get a recommendation to use marijuana which is given on a State approved form
- Patient mails that form and registration fee to the State
- State mail them back a red card
- Patient may also register a primary center or a primary caregiver which entitles that person or business to grow 6 plants on behalf of the patient, and an adult resident may grow up to six plants per person.
- Patient may change this registration once every 30 days but it may not take effect until the plants are done growing at the previous location

PATIENTS, CAREGIVERS AND PHYSICIANS: ENSURING LEGAL COMPLIANCE

- All properly registered patients are issued a medical marijuana card known as a “red card.”
- The card is valid for one year.
- MMC’s are required to make sure the card is not expired and that the patient name matches the driver’s license of the patient.
- The patient number on the card is entered into the MMC’s computer system every visit.
- One exception is patients may shop while waiting for their initial red card. Must have doctor’s recommendation and certified mail receipt to show your application has been sent to the state. This method is valid for 35 days.

TYPES OF CONTRACTS

- Cannabis Distribution Agreement
- Company Acquisition Contracts
  - Membership Interest Agreement
  - Asset Purchase Agreement
- Employment Agreements
- Licensing and Trademark Agreements
- MGMT
- OA
- Product
- Consult
- Manufacturing
- Testing
- Prom Notes
- Transport
- Future Ownership

ENFORCEABILITY

- Activities that are legal under state law but illegal under federal law rely on courts or state legislatures to decide whether the contracts involving the activity are illicit and therefore void under contract law.
- Marijuana business contracts are generally enforceable.
- In West v. Portnoy (Arapahoe County), a marijuana contract was found to be enforceable.
- California recently revised its Contract law to protect Cannabis Contracts on January 1, 2018.
- Statute C.R.S. 13.22.601: Contracts pertaining to marijuana enforceable.

FEDERAL ILLEGALITY ACKNOWLEDGEMENT

- Parties may attempt to use federal law as a defense to breach of a contract since the contract is illegal under federal law.
- Place an express provision in the contract to provide that federal law shall not be a defense to breach of the contract.
- Add termination clause to allow the agreement to be terminated or ended under circumstances specified in the clause.

CONTRACTING AGAINST REGULATIONS

- Standard form contracts may include terms that violate state marijuana statutes and regulations.
- Provisions to watch for:
  - Landlord entry provisions in leases.
  - Repossession/entry in equipment leases.
  - Security in loans and leases (ownership interest).
  - Inspection clauses in loans and leases.
  - Agreements with percentage of profit as consideration.

CHOICE OF LAW

- Contracts with marijuana businesses should always contain choice of law and venue provisions.
- Unlike other contracts, the choice of law MUST be the state where the business is licensed, and the venue MUST be in the state where the business is licensed.
- Colorado: Enforceable by State Statute
  - C.R.S. § 13-22-601 Contracts pertaining to marijuana enforceable:

    "It is the public policy of the state of Colorado that a contract is not void or voidable as against public policy if it pertains to lawful activities authorized by section 16 of article XVIII of the state constitution and article 43.4 of title 12, C.R.S."
- Pay attention to form contracts from national businesses.

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Controlled Substances Act

TITLE 21 - FOOD AND DRUGS
CHAPTER 13 - DRUG ABUSE PREVENTION AND CONTROL
SUBCHAPTER I - CONTROL AND ENFORCEMENT

PART A - INTRODUCTORY PROVISIONS

§ 801 Note Short Title

This title may be cited as the 'Controlled Substances Act'.

§ 801. Congressional findings and declarations: controlled substances.

The Congress makes the following findings and declarations:

- (1) Many of the drugs included within this subchapter have a useful and legitimate medical purpose and are necessary to maintain the health and general welfare of the American people.
- (2) The illegal importation, manufacture, distribution, and possession and improper use of controlled substances have a substantial and detrimental effect on the health and general welfare of the American people.
- (3) A major portion of the traffic in controlled substances flows through interstate and foreign commerce. Incidents of the traffic which are not an integral part of the interstate or foreign flow, such as manufacture, local distribution, and possession, nonetheless have a substantial and direct effect upon interstate commerce because -
    - (A) after manufacture, many controlled substances are transported in interstate commerce,
    - (B) controlled substances distributed locally usually have been transported in interstate commerce immediately before their distribution, and
    - (C) controlled substances possessed commonly flow through interstate commerce immediately prior to such possession.
- (4) Local distribution and possession of controlled substances contribute to swelling the interstate traffic in such substances.
- (5) Controlled substances manufactured and distributed intrastate cannot be differentiated from controlled substances manufactured and distributed interstate. Thus, it is not feasible to distinguish, in terms of controls, between controlled substances manufactured and distributed interstate and controlled substances manufactured and distributed intrastate.
- (6) Federal control of the intrastate incidents of the traffic in controlled substances is essential to the effective control of the interstate incidents of such traffic.

- (7) The United States is a party to the Single Convention on Narcotic Drugs, 1961, and other international conventions designed to establish effective control over international and domestic traffic in controlled substances.

§ 801a. Congressional findings and declarations: psychotropic substances.

The Congress makes the following findings and declarations:

- (1) The Congress has long recognized the danger involved in the manufacture, distribution, and use of certain psychotropic substances for nonscientific and nonmedical purposes, and has provided strong and effective legislation to control illicit trafficking and to regulate legitimate uses of psychotropic substances in this country. Abuse of psychotropic substances has become a phenomenon common to many countries, however, and is not confined to national borders. It is, therefore, essential that the United States cooperate with other nations in establishing effective controls over international traffic in such substances.
- (2) The United States has joined with other countries in executing an international treaty, entitled the Convention on Psychotropic Substances and signed at Vienna, Austria, on February 21, 1971, which is designed to establish suitable controls over the manufacture, distribution, transfer, and use of certain psychotropic substances. The Convention is not self-executing, and the obligations of the United States thereunder may only be performed pursuant to appropriate legislation. It is the intent of the Congress that the amendments made by this Act, together with existing law, will enable the United States to meet all of its obligations under the Convention and that no further legislation will be necessary for that purpose.
- (3) In implementing the Convention on Psychotropic Substances, the Congress intends that, consistent with the obligations of the United States under the Convention, control of psychotropic substances in the United States should be accomplished within the framework of the procedures and criteria for classification of substances provided in the Comprehensive Drug Abuse Prevention and Control Act of 1970 (21 U.S.C. 801 et seq.). This will insure that
    - (A) the availability of psychotropic substances to manufacturers, distributors, dispensers, and researchers for useful and legitimate medical and scientific purposes will not be unduly restricted;
    - (B) nothing in the Convention will interfere with bona fide research activities; and
    - (C) nothing in the Convention will interfere with ethical medical practice in this country as determined by the Secretary of Health and Human Services on the basis of a consensus of the views of the American medical and scientific community.

§ 802. Definitions.

As used in this subchapter:

- (1) The term "addict" means any individual who habitually uses any narcotic drug so as to endanger the public morals, health, safety, or welfare, or who is so far addicted to the use of narcotic drugs as to have lost the power of self-control with reference to his addiction.
- (2) The term "administer" refers to the direct application of a controlled substance to the body of a patient or research subject by -
    - (A) a practitioner (or, in his presence, by his authorized agent), or
    - (B) the patient or research subject at the direction and in the presence of the practitioner, whether such application be by injection, inhalation, ingestion, or any other means.
- (3) The term "agent" means an authorized person who acts on behalf of or at the direction of a manufacturer, distributor, or dispenser; except that such term does not include a common or contract carrier, public warehouseman, or employee of the carrier or warehouseman, when acting in the usual and lawful course of the carrier's or warehouseman's business.
- (4) The term "Drug Enforcement Administration" means the Drug Enforcement Administration in the Department of Justice.
- (5) The term "control" means to add a drug or other substance, or immediate precursor, to a schedule under part B of this subchapter, whether by transfer from another schedule or otherwise.
- (6) The term "controlled substance" means a drug or other substance, or immediate precursor, included in schedule I, II, III, IV, or V of part B of this subchapter. The term does not include distilled spirits, wine, malt beverages, or tobacco, as those terms are defined or used in subtitle E of the Internal Revenue Code of 1986.
- (7) The term "counterfeit substance" means a controlled substance which, or the container or labeling of which, without authorization, bears the trademark, trade name, or other identifying mark, imprint, number, or device, or any likeness thereof, of a manufacturer, distributor, or dispenser other than the person or persons who in fact manufactured, distributed, or dispensed such substance and which thereby falsely purports or is represented to be the product of, or to have been distributed by, such other manufacturer, distributor, or dispenser.
- (8) The terms "deliver" or "delivery" mean the actual, constructive, or attempted transfer of a controlled substance or a listed chemical, whether or not there exists an agency relationship.
- (9) The term "depressant or stimulant substance" means -
    - (A) a drug which contains any quantity of (i) barbituric acid or any of the salts of barbituric acid; or (ii) any derivative of barbituric acid which has been designated by the Secretary as habit forming under section 352(d) of this title; or
    - (B) a drug which contains any quantity of (i) amphetamine or any of its optical isomers; (ii) any salt of amphetamine or any salt of an optical isomer of amphetamine; or (iii) any substance which the Attorney General, after investigation, has found to be, and by regulation designated as, habit forming because of its stimulant effect on the central nervous systems; or

- (C) lysergic acid diethylamide; or
- (D) any drug which contains any quantity of a substance which the Attorney General, after investigation, has found to have, and by regulation designated as having, a potential for abuse because of its depressant or stimulant effect on the central nervous system or its hallucinogenic effect.

- (10) The term "dispense" means to deliver a controlled substance to an ultimate user or research subject by, or pursuant to the lawful order of, a practitioner, including the prescribing and administering of a controlled substance and the packaging, labeling or compounding necessary to prepare the substance for such delivery. The term "dispenser" means a practitioner who so delivers a controlled substance to an ultimate user or research subject.
- (11) The term "distribute" means to deliver (other than by administering or dispensing) a controlled substance or a listed chemical. The term "distributor" means a person who so delivers a controlled substance or a listed chemical.
- (12) The term "drug" has the meaning given that term by section 321(g)(1) of this title.
- (13) The term "felony" means any Federal or State offense classified by applicable Federal or State law as a felony.
- (14) The term "isomer" means the optical isomer, except as used in schedule I(c) and schedule II(a)(4). As used in schedule I(c), the term "isomer" means any optical, positional, or geometric isomer. As used in schedule II(a)(4), the term "isomer" means any optical or geometric isomer.
- (15) The term "manufacture" means the production, preparation, propagation, compounding, or processing of a drug or other substance, either directly or indirectly or by extraction from substances of natural origin, or independently by means of chemical synthesis or by a combination of extraction and chemical synthesis, and includes any packaging or repackaging of such substance or labeling or relabeling of its container; except that such term does not include the preparation, compounding, packaging, or labeling of a drug or other substance in conformity with applicable State or local law by a practitioner as an incident to his administration or dispensing of such drug or substance in the course of his professional practice. The term "manufacturer" means a person who manufactures a drug or other substance.
- (16) The term "marihuana" means all parts of the plant Cannabis sativa L., whether growing or not; the seeds thereof; the resin extracted from any part of such plant; and every compound, manufacture, salt, derivative, mixture, or preparation of such plant, its seeds or resin. Such term does not include the mature stalks of such plant, fiber produced from such stalks, oil or cake made from the seeds of such plant, any other compound, manufacture, salt, derivative, mixture, or preparation of such mature stalks (except the resin extracted therefrom), fiber, oil, or cake, or the sterilized seed of such plant which is incapable of germination.
- (17) The term "narcotic drug" means any of the following whether produced directly or indirectly by extraction from substances of vegetable origin, or independently by means of chemical synthesis, or by a combination of extraction and chemical synthesis:

    - (A) Opium, opiates, derivatives of opium and opiates, including their isomers, esters, ethers, salts, and salts of isomers, esters, and ethers, whenever the existence of such isomers, esters, ethers, and salts is possible within the specific chemical designation. Such term does not include the isoquinoline alkaloids of opium.
    - (B) Poppy straw and concentrate of poppy straw.
    - (C) Coca leaves, except coca leaves and extracts of coca leaves from which cocaine, ecgonine, and derivatives of ecgonine or their salts have been removed.
    - (D) Cocaine, its salts, optical and geometric isomers, and salts of isomers.
    - (E) Ecgonine, its derivatives, their salts, isomers, and salts of isomers.
    - (F) Any compound, mixture, or preparation which contains any quantity of any of the substances referred to in subparagraphs (A) through (E).
- (18) The term "opiate" means any drug or other substance having an addiction-forming or addiction-sustaining liability similar to morphine or being capable of conversion into a drug having such addiction-forming or addiction-sustaining liability.
- (19) The term "opium poppy" means the plant of the species Papaver somniferum L., except the seed thereof.
- (20) The term "poppy straw" means all parts, except the seeds, of the opium poppy, after mowing.
- (21) The term "practitioner" means a physician, dentist, veterinarian, scientific investigator, pharmacy, hospital, or other person licensed, registered, or otherwise permitted, by the United States or the jurisdiction in which he practices or does research, to distribute, dispense, conduct research with respect to, administer, or use in teaching or chemical analysis, a controlled substance in the course of professional practice or research.
- (22) The term "production" includes the manufacture, planting, cultivation, growing, or harvesting of a controlled substance.
- (23) The term "immediate precursor" means a substance -
    - (A) which the Attorney General has found to be and by regulation designated as being the principal compound used, or produced primarily for use, in the manufacture of a controlled substance;
    - (B) which is an immediate chemical intermediary used or likely to be used in the manufacture of such controlled substance; and
    - (C) the control of which is necessary to prevent, curtail, or limit the manufacture of such controlled substance.
- (24) The term "Secretary", unless the context otherwise indicates, means the Secretary of Health and Human Services.
- (25) The term "serious bodily injury" means bodily injury which involves -
    - (A) a substantial risk of death;
    - (B) protracted and obvious disfigurement; or
    - (C) protracted loss or impairment of the function of a bodily member, organ, or mental faculty.

- (26) The term "State" means any State, territory, or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Trust Territory of the Pacific Islands, and the Canal Zone.
- (27) The term "ultimate user" means a person who has lawfully obtained, and who possesses, a controlled substance for his own use or for the use of a member of his household or for an animal owned by him or by a member of his household.
- (28) The term "United States", when used in a geographic sense, means all places and waters, continental or insular, subject to the jurisdiction of the United States.
- (29) The term "maintenance treatment" means the dispensing, for a period in excess of twenty-one days, of a narcotic drug in the treatment of an individual for dependence upon heroin or other morphine-like drugs.
- (30) The term "detoxification treatment" means the dispensing, for a period not in excess of one hundred and eighty days, of a narcotic drug in decreasing doses to an individual in order to alleviate adverse physiological or psychological effects incident to withdrawal from the continuous or sustained use of a narcotic drug and as a method of bringing the individual to a narcotic drug-free state within such period.
- (31) The term "Convention on Psychotropic Substances" means the Convention on Psychotropic Substances signed at Vienna, Austria, on February 21, 1971; and the term "Single Convention on Narcotic Drugs" means the Single Convention on Narcotic Drugs signed at New York, New York, on March 30, 1961.
- (32)
    - (A) Except as provided in subparagraph (B), the term "controlled substance analogue" means a substance -
        - (i) the chemical structure of which is substantially similar to the chemical structure of a controlled substance in schedule I or II;
        - (ii) which has a stimulant, depressant, or hallucinogenic effect on the central nervous system that is substantially similar to or greater than the stimulant, depressant, or hallucinogenic effect on the central nervous system of a controlled substance in schedule I or II; or
        - (iii) with respect to a particular person, which such person represents or intends to have a stimulant, depressant, or hallucinogenic effect on the central nervous system that is substantially similar to or greater than the stimulant, depressant, or hallucinogenic effect on the central nervous system of a controlled substance in schedule I or II.
    - (B) Such term does not include -
        - (i) a controlled substance;
        - (ii) any substance for which there is an approved new drug application;
        - (iii) with respect to a particular person any substance, if an exemption is in effect for investigational use, for that person, under section 355 of this title to the extent conduct with respect to such substance is pursuant to such exemption; or

        - (iv) any substance to the extent not intended for human consumption before such an exemption takes effect with respect to that substance.
- (33) The term "listed chemical" means any list I chemical or any list II chemical.
- (34) The term "list I chemical" means a chemical specified by regulation of the Attorney General as a chemical that is used in manufacturing a controlled substance in violation of this subchapter and is important to the manufacture of the controlled substances, and such term includes (until otherwise specified by regulation of the Attorney General, as considered appropriate by the Attorney General or upon petition to the Attorney General by any person) the following:
    - (A) Anthranilic acid, its esters, and its salts.
    - (B) Benzyl cyanide.
    - (C) Ephedrine, its salts, optical isomers, and salts of optical isomers.
    - (D) Ergonovine and its salts.
    - (E) Ergotamine and its salts.
    - (F) N-Acetylanthranilic acid, its esters, and its salts.
    - (G) Norpseudoephedrine, its salts, optical isomers, and salts of optical isomers.
    - (H) Phenylacetic acid, its esters, and its salts.
    - (I) Phenylpropanolamine, its salts, optical isomers, and salts of optical isomers.
    - (J) Piperidine and its salts.
    - (K) Pseudoephedrine, its salts, optical isomers, and salts of optical isomers.
    - (L) 3,4-Methylenedioxyphenyl-2-propanone.
    - (M) Methylamine.
    - (N) Ethylamine.
    - (O) Propionic anhydride.
    - (P) Insosafrole.
    - (Q) Safrole.
    - (R) Piperonal.
    - (S) N-Methylepherdrine. (FOOTNOTE 1) (FOOTNOTE 1) So in original. Probably should be "N-Methylephedrine."
    - (T) N-methylpseudoephedrine.
    - (U) Hydriotic (FOOTNOTE 2) acid. (FOOTNOTE 2) So in original. Probably should be "Hydriodic".
    - (V) Benzaldehyde.
    - (W) Nitroethane.
    - (X) Any salt, optical isomer, or salt of an optical isomer of the chemicals listed in subparagraphs (M) through (U) of this paragraph.
- (35) The term "list II chemical" means a chemical (other than a list I chemical) specified by regulation of the Attorney General as a chemical that is used in manufacturing a controlled substance in violation of this subchapter, and such term includes (until otherwise specified by regulation of the Attorney General, as considered appropriate by the Attorney General or upon petition to the Attorney General by any person) the following chemicals:

    - (A) Acetic anhydride.
    - (B) Acetone.
    - (C) Benzyl chloride.
    - (D) Ethyl ether.
    - (E) Repealed. Pub. L. 101-647, title XXIII, Sec. 2301(b), Nov. 29, 1990, 104 Stat. 4858.
    - (F) Potassium permanganate.
    - (G) 2-Butanone.
    - (H) Toluene.
- (36) The term "regular customer" means, with respect to a regulated person, a customer with whom the regulated person has an established business relationship that is reported to the Attorney General.
- (37) The term "regular importer" means, with respect to a listed chemical, a person that has an established record as an importer of that listed chemical that is reported to the Attorney General.
- (38) The term "regulated person" means a person who manufactures, distributes, imports, or exports a listed chemical, a tableting machine, or an encapsulating machine or who acts as a broker or trader for an international transaction involving a listed chemical, a tableting machine, or an encapsulating machine.
- (39) The term "regulated transaction" means -
    - (A) a distribution, receipt, sale, importation, or exportation of, or an international transaction involving shipment of, a listed chemical, or if the Attorney General establishes a threshold amount for a specific listed chemical, a threshold amount, including a cumulative threshold amount for multiple transactions (as determined by the Attorney General, in consultation with the chemical industry and taking into consideration the quantities normally used for lawful purposes), of a listed chemical, except that such term does not include -
        - (i) a domestic lawful distribution in the usual course of business between agents or employees of a single regulated person;
        - (ii) a delivery of a listed chemical to or by a common or contract carrier for carriage in the lawful and usual course of the business of the common or contract carrier, or to or by a warehouseman for storage in the lawful and usual course of the business of the warehouseman, except that if the carriage or storage is in connection with the distribution, importation, or exportation of a listed chemical to a third person, this clause does not relieve a distributor, importer, or exporter from compliance with section 830 of this title;
        - (iii) any category of transaction or any category of transaction for a specific listed chemical or chemicals specified by regulation of the Attorney General as excluded from this definition as unnecessary for enforcement of this subchapter or subchapter II of this chapter;
        - (iv) any transaction in a listed chemical that is contained in a drug that may be marketed or distributed lawfully in the United States

under the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 301 et seq.) unless -

- (I)
  - (aa) the drug contains ephedrine or its salts, optical isomers, or salts of optical isomers as the only active medicinal ingredient or contains ephedrine or its salts, optical isomers, or salts of optical isomers and therapeutically insignificant quantities of another active medicinal ingredient; or
  - (bb) the Attorney General has determined under section 814 of this title that the drug or group of drugs is being diverted to obtain the listed chemical for use in the illicit production of a controlled substance; and
- (II) the quantity of ephedrine or other listed chemical contained in the drug included in the transaction or multiple transactions equals or exceeds the threshold established for that chemical by the Attorney General; or

- (v) any transaction in a chemical mixture which the Attorney General has by regulation designated as exempt from the application of this subchapter and subchapter II of this chapter based on a finding that the mixture is formulated in such a way that it cannot be easily used in the illicit production of a controlled substance and that the listed chemical or chemicals contained in the mixture cannot be readily recovered; and

- (B) a distribution, importation, or exportation of a tableting machine or encapsulating machine.

- (40) The term "chemical mixture" means a combination of two or more chemical substances, at least one of which is not a list I chemical or a list II chemical, except that such term does not include any combination of a list I chemical or a list II chemical with another chemical that is present solely as an impurity.
- (41)
  - (A) The term "anabolic steroid" means any drug or hormonal substance, chemically and pharmacologically related to testosterone (other than estrogens, progestins, and corticosteroids) that promotes muscle growth, and includes -
    - (i) boldenone,
    - (ii) chlorotestosterone,
    - (iii) clostebol,
    - (iv) dehydrochlormethyltestosterone,
    - (v) dihydrotestosterone,
    - (vi) drostanolone,
    - (vii) ethylestrenol,
    - (viii) fluoxymesterone,
    - (ix) formebulone,
    - (x) mesterolone,

        - (xi) methandienone,
        - (xii) methandranone,
        - (xiii) methandriol,
        - (xiv) methandrostenolone,
        - (xv) methenolone,
        - (xvi) methyltestosterone,
        - (xvii) mibolerone,
        - (xviii) nandrolone,
        - (xix) norethandrolone,
        - (xx) oxandrolone,
        - (xxi) oxymesterone,
        - (xxii) oxymetholone,
        - (xxiii) stanolone,
        - (xxiv) stanozolol,
        - (xxv) testolactone,
        - (xxvi) testosterone,
        - (xxvii) trenbolone, and (xxviii) any salt, ester, or isomer of a drug or substance described or listed in this paragraph, if that salt, ester, or isomer promotes muscle growth.
    - (B)
        - (i) Except as provided in clause (ii), such term does not include an anabolic steroid which is expressly intended for administration through implants to cattle or other nonhuman species and which has been approved by the Secretary of Health and Human Services for such administration.
        - (ii) If any person prescribes, dispenses, or distributes such steroid for human use, such person shall be considered to have prescribed, dispensed, or distributed an anabolic steroid within the meaning of subparagraph (A).
- (42) The term "international transaction" means a transaction involving the shipment of a listed chemical across an international border (other than a United States border) in which a broker or trader located in the United States participates.
- (43) The terms "broker" and "trader" mean a person that assists in arranging an international transaction in a listed chemical by -
    - (A) negotiating contracts;
    - (B) serving as an agent or intermediary; or
    - (C) bringing together a buyer and seller, a buyer and transporter, or a seller and transporter.
- (43) (FOOTNOTE 3) The term "felony drug offense" means an offense that is punishable by imprisonment for more than one year under any law of the United States or of a State or foreign country that prohibits or restricts conduct relating to narcotic drugs, marihuana, or depressant or stimulant substances. (FOOTNOTE 3) So in original. Probably should be "(44)".

§ 803. Repealed.

PART B - AUTHORITY TO CONTROL; STANDARDS AND SCHEDULES

§ 811. Authority and criteria for classification of substances.

- **(a) Rules and regulations of Attorney General; hearing**

The Attorney General shall apply the provisions of this subchapter to the controlled substances listed in the schedules established by section 812 of this title and to any other drug or other substance added to such schedules under this subchapter. Except as provided in subsections (d) and (e) of this section, the Attorney General may by rule -

- (1) add to such a schedule or transfer between such schedules any drug or other substance if he -
  - (A) finds that such drug or other substance has a potential for abuse, and
  - (B) makes with respect to such drug or other substance the findings prescribed by subsection (b) of section 812 of this title for the schedule in which such drug is to be placed; or
- (2) remove any drug or other substance from the schedules if he finds that the drug or other substance does not meet the requirements for inclusion in any schedule.

Rules of the Attorney General under this subsection shall be made on the record after opportunity for a hearing pursuant to the rulemaking procedures prescribed by subchapter II of chapter 5 of title 5. Proceedings for the issuance, amendment, or repeal of such rules may be initiated by the Attorney General (1) on his own motion, (2) at the request of the Secretary, or (3) on the petition of any interested party.

- **(b) Evaluation of drugs and other substances**

The Attorney General shall, before initiating proceedings under subsection (a) of this section to control a drug or other substance or to remove a drug or other substance entirely from the schedules, and after gathering the necessary data, request from the Secretary a scientific and medical evaluation, and his recommendations, as to whether such drug or other substance should be so controlled or removed as a controlled substance. In making such evaluation and recommendations, the Secretary shall consider the factors listed in paragraphs (2), (3), (6), (7), and (8) of subsection (c) of this section and any scientific or medical considerations involved in paragraphs (1), (4), and (5) of such subsection. The recommendations of the Secretary shall include recommendations with respect to the appropriate schedule, if any, under which such drug or other substance should be listed. The evaluation and the recommendations of the Secretary shall be made in writing and submitted to the Attorney General within a reasonable time. The recommendations of the Secretary to the Attorney General shall be binding on the

Attorney General as to such scientific and medical matters, and if the Secretary recommends that a drug or other substance not be controlled, the Attorney General shall not control the drug or other substance. If the Attorney General determines that these facts and all other relevant data constitute substantial evidence of potential for abuse such as to warrant control or substantial evidence that the drug or other substance should be removed entirely from the schedules, he shall initiate proceedings for control or removal, as the case may be, under subsection (a) of this section.

- **(c) Factors determinative of control or removal from schedules**

In making any finding under subsection (a) of this section or under subsection (b) of section 812 of this title, the Attorney General shall consider the following factors with respect to each drug or other substance proposed to be controlled or removed from the schedules:

- (1) Its actual or relative potential for abuse.
- (2) Scientific evidence of its pharmacological effect, if known.
- (3) The state of current scientific knowledge regarding the drug or other substance.
- (4) Its history and current pattern of abuse.
- (5) The scope, duration, and significance of abuse.
- (6) What, if any, risk there is to the public health.
- (7) Its psychic or physiological dependence liability.
- (8) Whether the substance is an immediate precursor of a substance already controlled under this subchapter.

- **(d) International treaties, conventions, and protocols requiring control; procedures respecting changes in drug schedules of Convention on Psychotropic Substances**
    - (1) If control is required by United States obligations under international treaties, conventions, or protocols in effect on October 27, 1970, the Attorney General shall issue an order controlling such drug under the schedule he deems most appropriate to carry out such obligations, without regard to the findings required by subsection (a) of this section or section 812(b) of this title and without regard to the procedures prescribed by subsections (a) and (b) of this section.
    - (2)
        - (A) Whenever the Secretary of State receives notification from the Secretary-General of the United Nations that information has been transmitted by or to the World Health Organization, pursuant to article 2 of the Convention on Psychotropic Substances, which may justify adding a drug or other substance to one of the schedules of the Convention, transferring a drug or substance from one schedule to another, or deleting it from the schedules, the Secretary of State shall immediately transmit the notice to the Secretary of Health and Human Services who shall publish it in the

Federal Register and provide opportunity to interested persons to submit to him comments respecting the scientific and medical evaluations which he is to prepare respecting such drug or substance. The Secretary of Health and Human Services shall prepare for transmission through the Secretary of State to the World Health Organization such medical and scientific evaluations as may be appropriate regarding the possible action that could be proposed by the World Health Organization respecting the drug or substance with respect to which a notice was transmitted under this subparagraph.

- (B) Whenever the Secretary of State receives information that the Commission on Narcotic Drugs of the United Nations proposes to decide whether to add a drug or other substance to one of the schedules of the Convention, transfer a drug or substance from one schedule to another, or delete it from the schedules, the Secretary of State shall transmit timely notice to the Secretary of Health and Human Services of such information who shall publish a summary of such information in the Federal Register and provide opportunity to interested persons to submit to him comments respecting the recommendation which he is to furnish, pursuant to this subparagraph, respecting such proposal. The Secretary of Health and Human Services shall evaluate the proposal and furnish a recommendation to the Secretary of State which shall be binding on the representative of the United States in discussions and negotiations relating to the proposal.

- (3) When the United States receives notification of a scheduling decision pursuant to article 2 of the Convention on Psychotropic Substances that a drug or other substance has been added or transferred to a schedule specified in the notification or receives notification (referred to in this subsection as a "schedule notice") that existing legal controls applicable under this subchapter to a drug or substance and the controls required by the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 301 et seq.) do not meet the requirements of the schedule of the Convention in which such drug or substance has been placed, the Secretary of Health and Human Services after consultation with the Attorney General, shall first determine whether existing legal controls under this subchapter applicable to the drug or substance and the controls required by the Federal Food, Drug, and Cosmetic Act, meet the requirements of the schedule specified in the notification or schedule notice and shall take the following action:
  - (A) If such requirements are met by such existing controls but the Secretary of Health and Human Services nonetheless believes that more stringent controls should be applied to the drug or substance, the Secretary shall recommend to the Attorney General that he initiate proceedings for scheduling the drug or substance, pursuant to subsections (a) and (b) of this section, to apply to such controls.

- (B) If such requirements are not met by such existing controls and the Secretary of Health and Human Services concurs in the scheduling decision or schedule notice transmitted by the notification, the Secretary shall recommend to the Attorney General that he initiate proceedings for scheduling the drug or substance under the appropriate schedule pursuant to subsections (a) and (b) of this section.
- (C) If such requirements are not met by such existing controls and the Secretary of Health and Human Services does not concur in the scheduling decision or schedule notice transmitted by the notification, the Secretary shall -
  - (i) if he deems that additional controls are necessary to protect the public health and safety, recommend to the Attorney General that he initiate proceedings for scheduling the drug or substance pursuant to subsections (a) and (b) of this section, to apply such additional controls;
  - (ii) request the Secretary of State to transmit a notice of qualified acceptance, within the period specified in the Convention, pursuant to paragraph 7 of article 2 of the Convention, to the Secretary-General of the United Nations;
  - (iii) request the Secretary of State to transmit a notice of qualified acceptance as prescribed in clause (ii) and request the Secretary of State to ask for a review by the Economic and Social Council of the United Nations, in accordance with paragraph 8 of article 2 of the Convention, of the scheduling decision; or
  - (iv) in the case of a schedule notice, request the Secretary of State to take appropriate action under the Convention to initiate proceedings to remove the drug or substance from the schedules under the Convention or to transfer the drug or substance to a schedule under the Convention different from the one specified in the schedule notice.

o (4)

- (A) If the Attorney General determines, after consultation with the Secretary of Health and Human Services, that proceedings initiated under recommendations made under paragraph (FOOTNOTE 1)
- (B) or (C)(i) of paragraph (3) will not be completed within the time period required by paragraph 7 of article 2 of the Convention, the Attorney General, after consultation with the Secretary and after providing interested persons opportunity to submit comments respecting the requirements of the temporary order to be issued under this sentence, shall issue a temporary order controlling the drug or substance under schedule IV or V, whichever is most appropriate to carry out the minimum United States obligations under paragraph 7 of article 2 of the Convention. As a part of such

order, the Attorney General shall, after consultation with the Secretary, except such drug or substance from the application of any provision of part C of this subchapter which he finds is not required to carry out the United States obligations under paragraph 7 of article 2 of the Convention. In the case of proceedings initiated under subparagraph (B) of paragraph (3), the Attorney General, concurrently with the issuance of such order, shall request the Secretary of State to transmit a notice of qualified acceptance to the Secretary-General of the United Nations pursuant to paragraph 7 of article 2 of the Convention. A temporary order issued under this subparagraph controlling a drug or other substance subject to proceedings initiated under subsections (a) and (b) of this section shall expire upon the effective date of the application to the drug or substance of the controls resulting from such proceedings. (FOOTNOTE 1) So in original. Probably should be "subparagraph".

- (B) After a notice of qualified acceptance of a scheduling decision with respect to a drug or other substance is transmitted to the Secretary-General of the United Nations in accordance with clause (ii) or (iii) of paragraph (3)(C) or after a request has been made under clause (iv) of such paragraph with respect to a drug or substance described in a schedule notice, the Attorney General, after consultation with the Secretary of Health and Human Services and after providing interested persons opportunity to submit comments respecting the requirements of the order to be issued under this sentence, shall issue an order controlling the drug or substance under schedule IV or V, whichever is most appropriate to carry out the minimum United States obligations under paragraph 7 of article 2 of the Convention in the case of a drug or substance for which a notice of qualified acceptance was transmitted or whichever the Attorney General determines is appropriate in the case of a drug or substance described in a schedule notice. As a part of such order, the Attorney General shall, after consultation with the Secretary, except such drug or substance from the application of any provision of part C of this subchapter which he finds is not required to carry out the United States obligations under paragraph 7 of article 2 of the Convention. If, as a result of a review under paragraph 8 of article 2 of the Convention of the scheduling decision with respect to which a notice of qualified acceptance was transmitted in accordance with clause (ii) or (iii) of paragraph (3)(C) -
    - (i) the decision is reversed, and
    - (ii) the drug or substance subject to such decision is not required to be controlled under schedule IV or V to carry out the minimum United States obligations under paragraph 7 of article 2 of the Convention,

the order issued under this subparagraph with respect to such drug or substance shall expire upon receipt by the United States of the review decision. If, as a result of action taken pursuant to action initiated under a request transmitted under clause (iv) of paragraph (3)(C), the drug or substance with respect to which such action was taken is not required to be controlled under schedule IV or V, the order issued under this paragraph with respect to such drug or substance shall expire upon receipt by the United States of a notice of the action taken with respect to such drug or substance under the Convention.

- (C) An order issued under subparagraph (A) or (B) may be issued without regard to the findings required by subsection (a) of this section or by section 812(b) of this title and without regard to the procedures prescribed by subsection (a) or (b) of this section.

(5) Nothing in the amendments made by the Psychotropic Substances Act of 1978 or the regulations or orders promulgated thereunder shall be construed to preclude requests by the Secretary of Health and Human Services or the Attorney General through the Secretary of State, pursuant to article 2 or other applicable provisions of the Convention, for review of scheduling decisions under such Convention, based on new or additional information.

- **(e) Immediate precursors**

The Attorney General may, without regard to the findings required by subsection (a) of this section or section 812(b) of this title and without regard to the procedures prescribed by subsections (a) and (b) of this section, place an immediate precursor in the same schedule in which the controlled substance of which it is an immediate precursor is placed or in any other schedule with a higher numerical designation. If the Attorney General designates a substance as an immediate precursor and places it in a schedule, other substances shall not be placed in a schedule solely because they are its precursors.

- **(f) Abuse potential**

If, at the time a new-drug application is submitted to the Secretary for any drug having a stimulant, depressant, or hallucinogenic effect on the central nervous system, it appears that such drug has an abuse potential, such information shall be forwarded by the Secretary to the Attorney General.

- **(g) Exclusion of non-narcotic substances sold over the counter without a prescription; dextromethorphan; exemption of substances lacking abuse potential**
    - (1) The Attorney General shall by regulation exclude any non-narcotic substance from a schedule if such substance may, under the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 301 et seq.), be lawfully sold over the counter without a prescription.
    - (2) Dextromethorphan shall not be deemed to be included in any schedule by reason of enactment of this subchapter unless controlled after October 27, 1970 pursuant to the foregoing provisions of this section.
    - (3) The Attorney General may, by regulation, exempt any compound, mixture, or preparation containing a controlled substance from the application of all or any part of this subchapter if he finds such compound, mixture, or preparation meets the requirements of one of the following categories:
        - (A) A mixture, or preparation containing a nonnarcotic controlled substance, which mixture or preparation is approved for prescription use, and which contains one or more other active ingredients which are not listed in any schedule and which are included therein in such combinations, quantity, proportion, or concentration as to vitiate the potential for abuse.
        - (B) A compound, mixture, or preparation which contains any controlled substance, which is not for administration to a human being or animal, and which is packaged in such form or concentration, or with adulterants or denaturants, so that as packaged it does not present any significant potential for abuse.

- **(h) Temporary scheduling to avoid imminent hazards to public safety**
    - (1) If the Attorney General finds that the scheduling of a substance in schedule I on a temporary basis is necessary to avoid an imminent hazard to the public safety, he may, by order and without regard to the requirements of subsection (b) of this section relating to the Secretary of Health and Human Services, schedule such substance in schedule I if the substance is not listed in any other schedule in section 812 of this title or if no exemption or approval is in effect for the substance under section 505 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 355). Such an order may not be issued before the expiration of thirty days from -
        - (A) the date of the publication by the Attorney General of a notice in the Federal Register of the intention to issue such order and the grounds upon which such order is to be issued, and
        - (B) the date the Attorney General has transmitted the notice required by paragraph (4).
- (2) The scheduling of a substance under this subsection shall expire at the end of one year from the date of the issuance of the order scheduling such substance, except that the Attorney General may, during the pendency of proceedings under

subsection (a)(1) of this section with respect to the substance, extend the temporary scheduling for up to six months.

- (3) When issuing an order under paragraph (1), the Attorney General shall be required to consider, with respect to the finding of an imminent hazard to the public safety, only those factors set forth in paragraphs (4), (5), and (6) of subsection (c) of this section, including actual abuse, diversion from legitimate channels, and clandestine importation, manufacture, or distribution.
- (4) The Attorney General shall transmit notice of an order proposed to be issued under paragraph (1) to the Secretary of Health and Human Services. In issuing an order under paragraph (1), the Attorney General shall take into consideration any comments submitted by the Secretary in response to a notice transmitted pursuant to this paragraph.
- (5) An order issued under paragraph (1) with respect to a substance shall be vacated upon the conclusion of a subsequent rulemaking proceeding initiated under subsection (a) of this section with respect to such substance.
- (6) An order issued under paragraph (1) is not subject to judicial review.

§ 812. Schedules of controlled substances.

- **(a) Establishment**

There are established five schedules of controlled substances, to be known as schedules I, II, III, IV, and V. Such schedules shall initially consist of the substances listed in this section. The schedules established by this section shall be updated and republished on a semiannual basis during the two-year period beginning one year after October 27, 1970, and shall be updated and republished on an annual basis thereafter.

- **(b) Placement on schedules; findings required**

Except where control is required by United States obligations under an international treaty, convention, or protocol, in effect on October 27, 1970, and except in the case of an immediate precursor, a drug or other substance may not be placed in any schedule unless the findings required for such schedule are made with respect to such drug or other substance. The findings required for each of the schedules are as follows:

- (1) Schedule I. -
  - (A) The drug or other substance has a high potential for abuse.
  - (B) The drug or other substance has no currently accepted medical use in treatment in the United States.
  - (C) There is a lack of accepted safety for use of the drug or other substance under medical supervision.
- (2) Schedule II. -
  - (A) The drug or other substance has a high potential for abuse.
  - (B) The drug or other substance has a currently accepted medical use in treatment in the United States or a currently accepted medical use with severe restrictions.

    - (C) Abuse of the drug or other substances may lead to severe psychological or physical dependence.
- (3) Schedule III. -
    - (A) The drug or other substance has a potential for abuse less than the drugs or other substances in schedules I and II.
    - (B) The drug or other substance has a currently accepted medical use in treatment in the United States.
    - (C) Abuse of the drug or other substance may lead to moderate or low physical dependence or high psychological dependence.
- (4) Schedule IV. -
    - (A) The drug or other substance has a low potential for abuse relative to the drugs or other substances in schedule III.
    - (B) The drug or other substance has a currently accepted medical use in treatment in the United States.
    - (C) Abuse of the drug or other substance may lead to limited physical dependence or psychological dependence relative to the drugs or other substances in schedule III.
- (5) Schedule V. -
    - (A) The drug or other substance has a low potential for abuse relative to the drugs or other substances in schedule IV.
    - (B) The drug or other substance has a currently accepted medical use in treatment in the United States.
    - (C) Abuse of the drug or other substance may lead to limited physical dependence or psychological dependence relative to the drugs or other substances in schedule IV.

- **(c) Initial schedules of controlled substances**

Schedules I, II, III, IV, and V shall, unless and until amended (FOOTNOTE 1) pursuant to section 811 of this title, consist of the following drugs or other substances, by whatever official name, common or usual name, chemical name, or brand name designated: (FOOTNOTE 1) Revised schedules are published in the Code of Federal Regulations, Part 1308 of Title 21, Food and Drugs.

SCHEDULE I

- **(a) Opiates**

Unless specifically excepted or unless listed in another schedule, any of the following opiates, including their isomers, esters, ethers, salts, and salts of isomers, esters, and ethers, whenever the existence of such isomers, esters, ethers, and salts is possible within the specific chemical designation:

- (1) Acetylmethadol.
- (2) Allylprodine.

- (3) Alphacetylmathadol. (FOOTNOTE 2) (FOOTNOTE 2) So in original. Probably should be "Alphacetylmethadol."
- (4) Alphameprodine.
- (5) Alphamethadol.
- (6) Benzethidine.
- (7) Betacetylmethadol.
- (8) Betameprodine.
- (9) Betamethadol.
- (10) Betaprodine.
- (11) Clonitazene.
- (12) Dextromoramide.
- (13) Dextrorphan.
- (14) Diampromide.
- (15) Diethylthiambutene.
- (16) Dimenoxadol.
- (17) Dimepheptanol.
- (18) Dimethylthiambutene.
- (19) Dioxaphetyl butyrate.
- (20) Dipipanone.
- (21) Ethylmethylthiambutene.
- (22) Etonitazene.
- (23) Etoxeridine.
- (24) Furethidine.
- (25) Hydroxypethidine.
- (26) Ketobemidone.
- (27) Levomoramide.
- (28) Levophenacylmorphan.
- (29) Morpheridine.
- (30) Noracymethadol.
- (31) Norlevorphanol.
- (32) Normethadone.
- (33) Norpipanone.
- (34) Phenadoxone.
- (35) Phenampromide.
- (36) Phenomorphan.
- (37) Phenoperidine.
- (38) Piritramide.
- (39) Propheptazine.
- (40) Properidine.
- (41) Racemoramide.
- (42) Trimeperidine.

- **(b) Opium Derivatives**

Unless specifically excepted or unless listed in another schedule, any of the following opium derivatives, their salts, isomers, and salt of isomers whenever the existence of such salts, isomers, and salts of isomers is possible within the specific chemical designation:

- (1) Acetorphine.
- (2) Acetyldihydrocodeine.
- (3) Benzylmorphine.
- (4) Codeine methylbromide.
- (5) Codeine-N-Oxide.
- (6) Cyprenorphine.
- (7) Desomorphine.
- (8) Dihydromorphine.
- (9) Etorphine.
- (10) Heroin.
- (11) Hydromorphinol.
- (12) Methyldesorphine.
- (13) Methylhydromorphine.
- (14) Morphine methylbromide.
- (15) Morphine methylsulfonate.
- (16) Morphine-N-Oxide.
- (17) Myrophine.
- (18) Nicocodeine.
- (19) Nicomorphine.
- (20) Normorphine.
- (21) Pholcodine.
- (22) Thebacon.

- **(c) Hallucinogenic Substances**

Unless specifically excepted or unless listed in another schedule, any material, compound, mixture, or preparation, which contains any quantity of the following hallucinogenic substances, or which contains any of their salts, isomers, and salts of isomers whenever the existence of such salts, isomers, and salts of isomers is possible within the specific chemical designation:

- (1) 3,4-methylenedioxy amphetamine.
- (2) 5-methoxy-3,4-methylenedioxy amphetamine.
- (3) 3,4,5-trimethoxy amphetamine.
- (4) Bufotenine.
- (5) Diethyltryptamine.
- (6) Dimethyltryptamine.
- (7) 4-methyl-2,5-diamethoxyamphetamine.
- (8) Ibogaine.
- (9) Lysergic acid diethylamide.
- (10) Marihuana.
- (11) Mescaline.

- (12) Peyote.
- (13) N-ethyl-3-piperidyl benzilate.
- (14) N-methyl-3-piperidyl benzilate.
- (15) Psilocybin.
- (16) Psilocyn.
- (17) Tetrahydrocannabinols.

SCHEDULE II

- **(a)**

Unless specifically excepted or unless listed in another schedule, any of the following substances whether produced directly or indirectly by extraction from substances of vegetable origin, or independently by means of chemical synthesis, or by a combination of extraction and chemical synthesis:

- (1) Opium and opiate, and any salt, compound, derivative, or preparation of opium or opiate.
- (2) Any salt, compound, derivative, or preparation thereof which is chemically equivalent or identical with any of the substances referred to in clause (1), except that these substances shall not include the isoquinoline alkaloids of opium.
- (3) Opium poppy and poppy straw.
- (4) coca (FOOTNOTE 3) leaves, except coca leaves and extracts of coca leaves from which cocaine, ecgonine, and derivatives of ecgonine or their salts have been removed; cocaine, its salts, optical and geometric isomers, and salts of isomers; ecgonine, its derivatives, their salts, isomers, and salts of isomers; or any compound, mixture, or preparation which contains any quantity of any of the substances referred to in this paragraph. (FOOTNOTE 3) So in original. Probably should be capitalized.

- **(b) Opiates**

Unless specifically excepted or unless listed in another schedule, any of the following opiates, including their isomers, esters, ethers, salts, and salts of isomers, esters and ethers, whenever the existence of such isomers, esters, ethers, and salts is possible within the specific chemical designation:

- (1) Alphaprodine.
- (2) Anileridine.
- (3) Bezitramide.
- (4) Dihydrocodeine.
- (5) Diphenoxylate.
- (6) Fentanyl.
- (7) Isomethadone.
- (8) Levomethorphan.
- (9) Levorphanol.

- (10) Metazocine.
- (11) Methadone.
- (12) Methadone-Intermediate, 4-cyano-2-dimethylamino-4,4-diphenyl butane.
- (13) Moramide-Intermediate, 2-methyl-3-morpholino-1, 1-diphenylpropane-carboxylic acid.
- (14) Pethidine.
- (15) Pethidine-Intermediate-A, 4-cyano-1-methyl-4-phenylpiperidine.
- (16) Pethidine-Intermediate-B, ethyl-4-phenylpiperidine-4-carboxylate.
- (17) Pethidine-Intermediate-C, 1-methyl-4-phenylpiperidine-4-carboxylic acid.
- (18) Phenazocine.
- (19) Piminodine.
- (20) Racemethorphan.
- (21) Racemorphan.

- **(c) Methamphetamine**

Unless specifically excepted or unless listed in another schedule, any injectable liquid which contains any quantity of methamphetamine, including its salts, isomers, and salts of isomers.

SCHEDULE III

- **(a) Stimulants**

Unless specifically excepted or unless listed in another schedule, any material, compound, mixture, or preparation which contains any quantity of the following substances having a stimulant effect on the central nervous system:

- (1) Amphetamine, its salts, optical isomers, and salts of its optical isomers.
- (2) Phenmetrazine and its salts.
- (3) Any substance (except an injectable liquid) which contains any quantity of methamphetamine, including its salts, isomers, and salts of isomers.
- (4) Methylphenidate.

- **(b) Depressants**

Unless specifically excepted or unless listed in another schedule, any material, compound, mixture, or preparation which contains any quantity of the following substances having a depressant effect on the central nervous system:

- (1) Any substance which contains any quantity of a derivative of barbituric acid, or any salt of a derivative of barbituric acid.
- (2) Chorhexadol.
- (3) Glutehimide.
- (4) Lysergic acid.
- (5) Lysergic acid amide.

- (6) Methyprylon.
- (7) Phencyclidine.
- (8) Sulfondiethylmethane.
- (9) Sulfonethylmethane.
- (10) Sulfonmethane.

- **(c) Nalorphine.**

- **(d) Narcotic Drug**

Unless specifically excepted or unless listed in another schedule, any material, compound, mixture, or preparation containing limited quantities of any of the following narcotic drugs, or any salts thereof:

- (1) Not more than 1.8 grams of codeine per 100 milliliters or not more than 90 milligrams per dosage unit, with an equal or greater quantity of an isoquinoline alkaloid of opium.
- (2) Not more than 1.8 grams of codeine per 100 milliliters or not more than 90 milligrams per dosage unit, with one or more active, non-narcotic ingredients in recognized therapeutic amounts.
- (3) Not more than 300 milligrams of dihydrocodeinone per 100 milliliters or not more than 15 milligrams per dosage unit, with a fourfold or greater quantity of an isoquinoline alkaloid of opium.
- (4) Not more than 300 milligrams of dihydrocodeinone per 100 milliliters or not more than 15 milligrams per dosage unit, with one or more active, nonnarcotic ingredients in recognized therapeutic amounts.
- (5) Not more than 1.8 grams of dihydrocodeine per 100 milliliters or not more than 90 milligrams per dosage unit, with one or more active, nonnarcotic ingredients in recognized therapeutic amounts.
- (6) Not more than 300 milligrams of ethylmorphine per 100 milliliters or not more than 15 milligrams per dosage unit, with one or more active, nonnarcotic ingredients in recognized therapeutic amounts.
- (7) Not more than 500 milligrams of opium per 100 milliliters or per 100 grams, or not more than 25 milligrams per dosage unit, with one or more active, nonnarcotic ingredients in recognized therapeutic amounts.
- (8) Not more than 50 milligrams of morphine per 100 milliliters or per 100 grams with one or more active, nonnarcotic ingredients in recognized therapeutic amounts.

- **(e) Anabolic steroids.**

SCHEDULE IV

- (1) Barbital.
- (2) Chloral betaine.
- (3) Chloral hydrate.

- (4) Ethchlorvynol.
- (5) Ethinamate.
- (6) Methohexital.
- (7) Meprobamate.
- (8) Methylphenobarbital.
- (9) Paraldehyde.
- (10) Petrichloral.
- (11) Phenobarbital.

SCHEDULE V

Any compound, mixture, or preparation containing any of the following limited quantities of narcotic drugs, which shall include one or more nonnarcotic active medicinal ingredients in sufficient proportion to confer upon the compound, mixture, or preparation valuable medicinal qualities other than those possessed by the narcotic drug alone:

- (1) Not more than 200 milligrams of codeine per 100 milliliters or per 100 grams.
- (2) Not more than 100 milligrams of dihydrocodeine per 100 milliliters or per 100 grams.
- (3) Not more than 100 milligrams of ethylmorphine per 100 milliliters or per 100 grams.
- (4) Not more than 2.5 milligrams of diphenoxylate and not less than 25 micrograms of atropine sulfate per dosage unit.
- (5) Not more than 100 milligrams of opium per 100 milliliters or per 100 grams.

§ 813. Treatment of controlled substance analogues.

A controlled substance analogue shall, to the extent intended for human consumption, be treated, for the purposes of any Federal law as a controlled substance in schedule I.

§ 814. Removal of exemption of certain drugs.

- **(a) Removal of exemption**

The Attorney General shall by regulation remove from exemption under section 802(39)(A)(iv) of this title a drug or group of drugs that the Attorney General finds is being diverted to obtain a listed chemical for use in the illicit production of a controlled substance.

- **(b) Factors to be considered**

In removing a drug or group of drugs from exemption under subsection (a) of this section, the Attorney General shall consider, with respect to a drug or group of drugs that is proposed to be removed from exemption -

- (1) the scope, duration, and significance of the diversion;
- (2) whether the drug or group of drugs is formulated in such a way that it cannot be easily used in the illicit production of a controlled substance; and
- (3) whether the listed chemical can be readily recovered from the drug or group of drugs.

- **(c) Specificity of designation**

The Attorney General shall limit the designation of a drug or a group of drugs removed from exemption under subsection (a) of this section to the most particularly identifiable type of drug or group of drugs for which evidence of diversion exists unless there is evidence, based on the pattern of diversion and other relevant factors, that the diversion will not be limited to that particular drug or group of drugs.

- **(d) Reinstatement of exemption with respect to particular drug products**
    - (1) Reinstatement On application by a manufacturer of a particular drug product that has been removed from exemption under subsection (a) of this section, the Attorney General shall by regulation reinstate the exemption with respect to that particular drug product if the Attorney General determines that the particular drug product is manufactured and distributed in a manner that prevents diversion.
    - (2) Factors to be considered In deciding whether to reinstate the exemption with respect to a particular drug product under paragraph (1), the Attorney General shall consider -
        - (A) the package sizes and manner of packaging of the drug product;
        - (B) the manner of distribution and advertising of the drug product;
        - (C) evidence of diversion of the drug product;
        - (D) any actions taken by the manufacturer to prevent diversion of the drug product; and
        - (E) such other factors as are relevant to and consistent with the public health and safety, including the factors described in subsection (b) of this section as applied to the drug product.
    - (3) Status pending application for reinstatement A transaction involving a particular drug product that is the subject of a bona fide pending application for reinstatement of exemption filed with the Attorney General not later than 60 days after a regulation removing the exemption is issued pursuant to subsection (a) of this section shall not be considered to be a regulated transaction if the transaction occurs during the pendency of the application and, if the Attorney General denies the application, during the period of 60 days following the date on which the Attorney General denies the application, unless -
        - (A) the Attorney General has evidence that, applying the factors described in subsection (b) of this section to the drug product, the drug product is being diverted; and
        - (B) the Attorney General so notifies the applicant.

- (4) Amendment and modification A regulation reinstating an exemption under paragraph (1) may be modified or revoked with respect to a particular drug product upon a finding that -
  - (A) applying the factors described in subsection (b) of this section to the drug product, the drug product is being diverted; or
  - (B) there is a significant change in the data that led to the issuance of the regulation.

PART C - REGISTRATION OF MANUFACTURERS, DISTRIBUTORS, AND DISPENSERS OF CONTROLLED SUBSTANCES

§ 821. Rules and regulations.

The Attorney General is authorized to promulgate rules and regulations and to charge reasonable fees relating to the registration and control of the manufacture, distribution, and dispensing of controlled substances and to the registration and control of regulated persons and of regulated transactions.

§ 822. Persons required to register.

- **(a) Period of registration**
  - (1) Every person who manufactures or distributes any controlled substance or list I chemical, or who proposes to engage in the manufacture or distribution of any controlled substance or list I chemical, shall obtain annually a registration issued by the Attorney General in accordance with the rules and regulations promulgated by him.
  - (2) Every person who dispenses, or who proposes to dispense, any controlled substance, shall obtain from the Attorney General a registration issued in accordance with the rules and regulations promulgated by him. The Attorney General shall, by regulation, determine the period of such registrations. In no event, however, shall such registrations be issued for less than one year nor for more than three years.

- **(b) Authorized activities**

Persons registered by the Attorney General under this subchapter to manufacture, distribute, or dispense controlled substances or list I chemicals are authorized to possess, manufacture, distribute, or dispense such substances or chemicals (including any such activity in the conduct of research) to the extent authorized by their registration and in conformity with the other provisions of this subchapter.

- **(c) Exceptions**

The following persons shall not be required to register and may lawfully possess any controlled substance or list I chemical under this subchapter:

- (1) An agent or employee of any registered manufacturer, distributor, or dispenser of any controlled substance or list I chemical if such agent or employee is acting in the usual course of his business or employment.
- (2) A common or contract carrier or warehouseman, or an employee thereof, whose possession of the controlled substance or list I chemical is in the usual course of his business or employment.
- (3) An ultimate user who possesses such substance for a purpose specified in section 802(25) (FOOTNOTE 1) of this title.

  (FOOTNOTE 1) Section 802(25) of this title, referred to in subsec. (c)(3), was redesignated section 802(26) of this title by Pub. L. 98-473, title II, Sec. 507(a), Oct. 12, 1984, 98 Stat. 2071, and was further redesignated section 802(27) of this title by Pub. L. 99-570, title I, Sec. 1003(b)(2), Oct. 27, 1986, 100 Stat. 3207-6.

- **(d) Waiver**

The Attorney General may, by regulation, waive the requirement for registration of certain manufacturers, distributors, or dispensers if he finds it consistent with the public health and safety.

- **(e) Separate registration**

A separate registration shall be required at each principal place of business or professional practice where the applicant manufactures, distributes, or dispenses controlled substances or list I chemicals.

- **(f) Inspection**

The Attorney General is authorized to inspect the establishment of a registrant or applicant for registration in accordance with the rules and regulations promulgated by him.

§ 823. Registration requirements.

- **(a) Manufacturers of controlled substances in schedule I or II**

The Attorney General shall register an applicant to manufacture controlled substances in schedule I or II if he determines that such registration is consistent with the public interest and with United States obligations under international treaties, conventions, or protocols in effect on May 1, 1971. In determining the public interest, the following factors shall be considered:

- (1) maintenance of effective controls against diversion of particular controlled substances and any controlled substance in schedule I or II compounded therefrom into other than legitimate medical, scientific, research, or industrial channels, by limiting the importation and bulk manufacture of such controlled substances to a number of establishments which can produce an adequate and uninterrupted supply of these substances under adequately competitive conditions for legitimate medical, scientific, research, and industrial purposes;
- (2) compliance with applicable State and local law;
- (3) promotion of technical advances in the art of manufacturing these substances and the development of new substances;
- (4) prior conviction record of applicant under Federal and State laws relating to the manufacture, distribution, or dispensing of such substances;
- (5) past experience in the manufacture of controlled substances, and the existence in the establishment of effective control against diversion; and
- (6) such other factors as may be relevant to and consistent with the public health and safety.

- **(b) Distributors of controlled substances in schedule I or II**

The Attorney General shall register an applicant to distribute a controlled substance in schedule I or II unless he determines that the issuance of such registration is inconsistent with the public interest. In determining the public interest, the following factors shall be considered:

- (1) maintenance of effective control against diversion of particular controlled substances into other than legitimate medical, scientific, and industrial channels;
- (2) compliance with applicable State and local law;
- (3) prior conviction record of applicant under Federal or State laws relating to the manufacture, distribution, or dispensing of such substances;
- (4) past experience in the distribution of controlled substances; and
- (5) such other factors as may be relevant to and consistent with the public health and safety.

- **(c) Limits of authorized activities**

Registration granted under subsections (a) and (b) of this section shall not entitle a registrant to (1) manufacture or distribute controlled substances in schedule I or II other than those specified in the registration, or (2) manufacture any quantity of those controlled substances in excess of the quota assigned pursuant to section 826 of this title.

- **(d) Manufacturers of controlled substances in schedule III, IV, or V**

The Attorney General shall register an applicant to manufacture controlled substances in schedule III, IV, or V, unless he determines that the issuance of such registration is inconsistent with the public interest. In determining the public interest, the following factors shall be considered:

- (1) maintenance of effective controls against diversion of particular controlled substances and any controlled substance in schedule III, IV, or V compounded therefrom into other than legitimate medical, scientific, or industrial channels;
- (2) compliance with applicable State and local law;
- (3) promotion of technical advances in the art of manufacturing these substances and the development of new substances;
- (4) prior conviction record of applicant under Federal or State laws relating to the manufacture, distribution, or dispensing of such substances;
- (5) past experience in the manufacture, distribution, and dispensing of controlled substances, and the existence in the establishment of effective controls against diversion; and
- (6) such other factors as may be relevant to and consistent with the public health and safety.

- **(e) Distributors of controlled substances in schedule III, IV, or V**

The Attorney General shall register an applicant to distribute controlled substances in schedule III, IV, or V, unless he determines that the issuance of such registration is inconsistent with the public interest. In determining the public interest, the following factors shall be considered:

- (1) maintenance of effective controls against diversion of particular controlled substances into other than legitimate medical, scientific, and industrial channels;
- (2) compliance with applicable State and local law;
- (3) prior conviction record of applicant under Federal or State laws relating to the manufacture, distribution, or dispensing of such substances;
- (4) past experience in the distribution of controlled substances; and
- (5) such other factors as may be relevant to and consistent with the public health and safety.

- **(f) Research by practitioners; pharmacies; research applications; construction of Article 7 of the Convention on Psychotropic Substances**

The Attorney General shall register practitioners (including pharmacies, as distinguished from pharmacists) to dispense, or conduct research with, controlled substances in schedule II, III, IV, or V, if the applicant is authorized to dispense, or conduct research with respect to, controlled substances under the laws of the State in which he practices. The Attorney General may deny an application for such registration if he determines that the issuance of such registration would be inconsistent with the public interest. In determining the public interest, the following factors shall be considered:

- (1) The recommendation of the appropriate State licensing board or professional disciplinary authority.
- (2) The applicant's experience in dispensing, or conducting research with respect to controlled substances.

- (3) The applicant's conviction record under Federal or State laws relating to the manufacture, distribution, or dispensing of controlled substances.
- (4) Compliance with applicable State, Federal, or local laws relating to controlled substances.
- (5) Such other conduct which may threaten the public health and safety.

Separate registration under this part for practitioners engaging in research with controlled substances in schedule II, III, IV, or V, who are already registered under this part in another capacity, shall not be required. Registration applications by practitioners wishing to conduct research with controlled substances in schedule I shall be referred to the Secretary, who shall determine the qualifications and competency of each practitioner requesting registration, as well as the merits of the research protocol. The Secretary, in determining the merits of each research protocol, shall consult with the Attorney General as to effective procedures to adequately safeguard against diversion of such controlled substances from legitimate medical or scientific use. Registration for the purpose of bona fide research with controlled substances in schedule I by a practitioner deemed qualified by the Secretary may be denied by the Attorney General only on a ground specified in section 824(a) of this title. Article 7 of the Convention on Psychotropic Substances shall not be construed to prohibit, or impose additional restrictions upon, research involving drugs or other substances scheduled under the convention which is conducted in conformity with this subsection and other applicable provisions of this subchapter.

- **(g) Practitioners dispensing narcotic drugs for narcotic treatment; annual registration; separate registration; qualifications**

Practitioners who dispense narcotic drugs to individuals for maintenance treatment or detoxification treatment shall obtain annually a separate registration for that purpose. The Attorney General shall register an applicant to dispense narcotic drugs to individuals for maintenance treatment or detoxification treatment (or both)

- (1) if the applicant is a practitioner who is determined by the Secretary to be qualified (under standards established by the Secretary) to engage in the treatment with respect to which registration is sought;
- (2) if the Attorney General determines that the applicant will comply with standards established by the Attorney General respecting (A) security of stocks of narcotic drugs for such treatment, and (B) the maintenance of records (in accordance with section 827 of this title) on such drugs; and
- (3) if the Secretary determines that the applicant will comply with standards established by the Secretary (after consultation with the Attorney General) respecting the quantities of narcotic drugs which may be provided for unsupervised use by individuals in such treatment.

- **(h) Applicants for distribution of list I chemicals**

The Attorney General shall register an applicant to distribute a list I chemical unless the Attorney General determines that registration of the applicant is inconsistent with the

public interest. Registration under this subsection shall not be required for the distribution of a drug product that is exempted under section 802(39)(A)(iv) of this title. In determining the public interest for the purposes of this subsection, the Attorney General shall consider -

- (1) maintenance by the applicant of effective controls against diversion of listed chemicals into other than legitimate channels;
- (2) compliance by the applicant with applicable Federal, State, and local law;
- (3) any prior conviction record of the applicant under Federal or State laws relating to controlled substances or to chemicals controlled under Federal or State law;
- (4) any past experience of the applicant in the manufacture and distribution of chemicals; and
- (5) such other factors as are relevant to and consistent with the public health and safety.

§ 824. Denial, revocation, or suspension of registration.

- **(a) Grounds**

A registration pursuant to section 823 of this title to manufacture, distribute, or dispense a controlled substance or a list I chemical may be suspended or revoked by the Attorney General upon a finding that the registrant -

- (1) has materially falsified any application filed pursuant to or required by this subchapter or subchapter II of this chapter;
- (2) has been convicted of a felony under this subchapter or subchapter II of this chapter or any other law of the United States, or of any State, relating to any substance defined in this subchapter as a controlled substance or a list I chemical;
- (3) has had his State license or registration suspended, revoked, or denied by competent State authority and is no longer authorized by State law to engage in the manufacturing, distribution, or dispensing of controlled substances or list I chemicals or has had the suspension, revocation, or denial of his registration recommended by competent State authority;
- (4) has committed such acts as would render his registration under section 823 of this title inconsistent with the public interest as determined under such section; or
- (5) has been excluded (or directed to be excluded) from participation in a program pursuant to section 1320a-7(a) of title 42.

A registration pursuant to section 823(g) of this title to dispense a narcotic drug for maintenance treatment or detoxification treatment may be suspended or revoked by the Attorney General upon a finding that the registrant has failed to comply with any standard referred to in section 823(g) of this title.

- **(b) Limits of revocation or suspension**

The Attorney General may limit revocation or suspension of a registration to the particular controlled substance or list I chemical with respect to which grounds for revocation or suspension exist.

- **(c) Service of show cause order; proceedings**

Before taking action pursuant to this section, or pursuant to a denial of registration under section 823 of this title, the Attorney General shall serve upon the applicant or registrant an order to show cause why registration should not be denied, revoked, or suspended. The order to show cause shall contain a statement of the basis thereof and shall call upon the applicant or registrant to appear before the Attorney General at a time and place stated in the order, but in no event less than thirty days after the date of receipt of the order. Proceedings to deny, revoke, or suspend shall be conducted pursuant to this section in accordance with subchapter II of chapter 5 of title 5. Such proceedings shall be independent of, and not in lieu of, criminal prosecutions or other proceedings under this subchapter or any other law of the United States.

- **(d) Suspension of registration in cases of imminent danger**

The Attorney General may, in his discretion, suspend any registration simultaneously with the institution of proceedings under this section, in cases where he finds that there is an imminent danger to the public health or safety. A failure to comply with a standard referred to in section 823(g) of this title may be treated under this subsection as grounds for immediate suspension of a registration granted under such section. A suspension under this subsection shall continue in effect until the conclusion of such proceedings, including judicial review thereof, unless sooner withdrawn by the Attorney General or dissolved by a court of competent jurisdiction.

- **(e) Suspension and revocation of quotas**

The suspension or revocation of a registration under this section shall operate to suspend or revoke any quota applicable under section 826 of this title.

- **(f) Disposition of controlled substances or list I chemicals**

In the event the Attorney General suspends or revokes a registration granted under section 823 of this title, all controlled substances or list I chemicals owned or possessed by the registrant pursuant to such registration at the time of suspension or the effective date of the revocation order, as the case may be, may, in the discretion of the Attorney General, be placed under seal. No disposition may be made of any controlled substances or list I chemicals under seal until the time for taking an appeal has elapsed or until all appeals have been concluded except that a court, upon application therefor, may at any time order the sale of perishable controlled substances or list I chemicals. Any such order shall require the deposit of the proceeds of the sale with the court. Upon a revocation order becoming final, all such controlled substances or list I chemicals (or proceeds of sale deposited in court) shall be forfeited to the United States; and the Attorney General

shall dispose of such controlled substances or list I chemicals in accordance with section 881(e) of this title. All right, title, and interest in such controlled substances or list I chemicals shall vest in the United States upon a revocation order becoming final.

- **(g) Seizure or placement under seal of controlled substances or list I chemicals**

The Attorney General may, in his discretion, seize or place under seal any controlled substances or list I chemicals owned or possessed by a registrant whose registration has expired or who has ceased to practice or do business in the manner contemplated by his registration. Such controlled substances or list I chemicals shall be held for the benefit of the registrant, or his successor in interest. The Attorney General shall notify a registrant, or his successor in interest, who has any controlled substance or list I chemical seized or placed under seal of the procedures to be followed to secure the return of the controlled substance or list I chemical and the conditions under which it will be returned. The Attorney General may not dispose of any controlled substance or list I chemical seized or placed under seal under this subsection until the expiration of one hundred and eighty days from the date such substance or chemical was seized or placed under seal.

§ 825. Labeling and packaging.

- **(a) Symbol**

It shall be unlawful to distribute a controlled substance in a commercial container unless such container, when and as required by regulations of the Attorney General, bears a label (as defined in section 321(k) of this title) containing an identifying symbol for such substance in accordance with such regulations. A different symbol shall be required for each schedule of controlled substances.

- **(b) Unlawful distribution without identifying symbol**

It shall be unlawful for the manufacturer of any controlled substance to distribute such substance unless the labeling (as defined in section 321(m) of this title) of such substance contains, when and as required by regulations of the Attorney General, the identifying symbol required under subsection (a) of this section.

- **(c) Warning on label**

The Secretary shall prescribe regulations under section 353(b) of this title which shall provide that the label of a drug listed in schedule II, III, or IV shall, when dispensed to or for a patient, contain a clear, concise warning that it is a crime to transfer the drug to any person other than the patient.

- **(d) Containers to be securely sealed**

It shall be unlawful to distribute controlled substances in schedule I or II, and narcotic drugs in schedule III or IV, unless the bottle or other container, stopper, covering, or wrapper thereof is securely sealed as required by regulations of the Attorney General.

§ 826. Production quotas for controlled substances.

- **(a) Establishment of total annual needs**

The Attorney General shall determine the total quantity and establish production quotas for each basic class of controlled substance in schedules I and II to be manufactured each calendar year to provide for the estimated medical, scientific, research, and industrial needs of the United States, for lawful export requirements, and for the establishment and maintenance of reserve stocks. Production quotas shall be established in terms of quantities of each basic class of controlled substance and not in terms of individual pharmaceutical dosage forms prepared from or containing such a controlled substance.

- **(b) Individual production quotas; revised quotas**

The Attorney General shall limit or reduce individual production quotas to the extent necessary to prevent the aggregate of individual quotas from exceeding the amount determined necessary each year by the Attorney General under subsection (a) of this section. The quota of each registered manufacturer for each basic class of controlled substance in schedule I or II shall be revised in the same proportion as the limitation or reduction of the aggregate of the quotas. However, if any registrant, before the issuance of a limitation or reduction in quota, has manufactured in excess of his revised quota, the amount of the excess shall be subtracted from his quota for the following year.

- **(c) Manufacturing quotas for registered manufacturers**

On or before October 1 of each year, upon application therefor by a registered manufacturer, the Attorney General shall fix a manufacturing quota for the basic classes of controlled substances in schedules I and II that the manufacturer seeks to produce. The quota shall be subject to the provisions of subsections (a) and (b) of this section. In fixing such quotas, the Attorney General shall determine the manufacturer's estimated disposal, inventory, and other requirements for the calendar year; and, in making his determination, the Attorney General shall consider the manufacturer's current rate of disposal, the trend of the national disposal rate during the preceding calendar year, the manufacturer's production cycle and inventory position, the economic availability of raw materials, yield and stability problems, emergencies such as strikes and fires, and other factors.

- **(d) Quotas for registrants who have not manufactured controlled substance during one or more preceding years**

The Attorney General shall, upon application and subject to the provisions of subsections (a) and (b) of this section, fix a quota for a basic class of controlled substance in schedule

I or II for any registrant who has not manufactured that basic class of controlled substance during one or more preceding calendar years. In fixing such quota, the Attorney General shall take into account the registrant's reasonably anticipated requirements for the current year; and, in making his determination of such requirements, he shall consider such factors specified in subsection (c) of this section as may be relevant.

- **(e) Quota increases**

At any time during the year any registrant who has applied for or received a manufacturing quota for a basic class of controlled substance in schedule I or II may apply for an increase in that quota to meet his estimated disposal, inventory, and other requirements during the remainder of that year. In passing upon the application the Attorney General shall take into consideration any occurrences since the filing of the registrant's initial quota application that may require an increased manufacturing rate by the registrant during the balance of the year. In passing upon the application the Attorney General may also take into account the amount, if any, by which the determination of the Attorney General under subsection (a) of this section exceeds the aggregate of the quotas of all registrants under this section.

- **(f) Incidental production exception**

Notwithstanding any other provisions of this subchapter, no registration or quota may be required for the manufacture of such quantities of controlled substances in schedules I and II as incidentally and necessarily result from the manufacturing process used for the manufacture of a controlled substance with respect to which its manufacturer is duly registered under this subchapter. The Attorney General may, by regulation, prescribe restrictions on the retention and disposal of such incidentally produced substances.

§ 827. Records and reports of registrants.

- **(a) Inventory**

Except as provided in subsection (c) of this section -

- (1) every registrant under this subchapter shall, on May 1, 1971, or as soon thereafter as such registrant first engages in the manufacture, distribution, or dispensing of controlled substances, and every second year thereafter, make a complete and accurate record of all stocks thereof on hand, except that the regulations prescribed under this section shall permit each such biennial inventory (following the initial inventory required by this paragraph) to be prepared on such registrant's regular general physical inventory date (if any) which is nearest to and does not vary by more than six months from the biennial date that would otherwise apply;
- (2) on the effective date of each regulation of the Attorney General controlling a substance that immediately prior to such date was not a controlled substance, each

registrant under this subchapter manufacturing, distributing, or dispensing such substance shall make a complete and accurate record of all stocks thereof on hand; and

- (3) on and after May 1, 1971, every registrant under this subchapter manufacturing, distributing, or dispensing a controlled substance or substances shall maintain, on a current basis, a complete and accurate record of each such substance manufactured, received, sold, delivered, or otherwise disposed of by him, except that this paragraph shall not require the maintenance of a perpetual inventory.

- **(b) Availability of records**

Every inventory or other record required under this section (1) shall be in accordance with, and contain such relevant information as may be required by, regulations of the Attorney General, (2) shall (A) be maintained separately from all other records of the registrant, or (B) alternatively, in the case of nonnarcotic controlled substances, be in such form that information required by the Attorney General is readily retrievable from the ordinary business records of the registrant, and (3) shall be kept and be available, for at least two years, for inspection and copying by officers or employees of the United States authorized by the Attorney General.

- **(c) Nonapplicability**

The foregoing provisions of this section shall not apply -

- (1)
  - (A) to the prescribing of controlled substances in schedule II, III, IV, or V by practitioners acting in the lawful course of their professional practice unless such substance is prescribed in the course of maintenance or detoxification treatment of an individual; or
  - (B) to the administering of a controlled substance in schedule II, III, IV, or V unless the practitioner regularly engages in the dispensing or administering of controlled substances and charges his patients, either separately or together with charges for other professional services, for substances so dispensed or administered or unless such substance is administered in the course of maintenance treatment or detoxification treatment of an individual;
- (2)
  - (A) to the use of controlled substances, at establishments registered under this subchapter which keep records with respect to such substances, in research conducted in conformity with an exemption granted under section 355(i) or 360b(j) of this title;
  - (B) to the use of controlled substances, at establishments registered under this subchapter which keep records with respect to such substances, in preclinical research or in teaching; or

- (3) to the extent of any exemption granted to any person, with respect to all or part of such provisions, by the Attorney General by or pursuant to regulation on the basis of a finding that the application of such provisions (or part thereof) to such person is not necessary for carrying out the purposes of this subchapter. Nothing in the Convention on Psychotropic Substances shall be construed as superseding or otherwise affecting the provisions of paragraph (1)(B), (2), or (3) of this subsection.

- **(d) Periodic reports to Attorney General**

Every manufacturer registered under section 823 of this title shall, at such time or times and in such form as the Attorney General may require, make periodic reports to the Attorney General of every sale, delivery or other disposal by him of any controlled substance, and each distributor shall make such reports with respect to narcotic controlled substances, identifying by the registration number assigned under this subchapter the person or establishment (unless exempt from registration under section 822(d) of this title) to whom such sale, delivery, or other disposal was made.

- **(e) Reporting and recordkeeping requirements of drug conventions**

In addition to the reporting and recordkeeping requirements under any other provision of this subchapter, each manufacturer registered under section 823 of this title shall, with respect to narcotic and nonnarcotic controlled substances manufactured by it, make such reports to the Attorney General, and maintain such records, as the Attorney General may require to enable the United States to meet its obligations under articles 19 and 20 of the Single Convention on Narcotic Drugs and article 16 of the Convention on Psychotropic Substances. The Attorney General shall administer the requirements of this subsection in such a manner as to avoid the unnecessary imposition of duplicative requirements under this subchapter on manufacturers subject to the requirements of this subsection.

- **(f) Investigational uses of drugs; procedures**

Regulations under sections 355(i) and 360(j) of this title, relating to investigational use of drugs, shall include such procedures as the Secretary, after consultation with the Attorney General, determines are necessary to insure the security and accountability of controlled substances used in research to which such regulations apply.

- **(g) Change of address**

Every registrant under this subchapter shall be required to report any change of professional or business address in such manner as the Attorney General shall by regulation require.

§ 828. Order forms.

- **(a) Unlawful distribution of controlled substances**

It shall be unlawful for any person to distribute a controlled substance in schedule I or II to another except in pursuance of a written order of the person to whom such substance is distributed, made on a form to be issued by the Attorney General in blank in accordance with subsection (d) of this section and regulations prescribed by him pursuant to this section.

- **(b) Nonapplicability of provisions**

Nothing in subsection (a) of this section shall apply to -

- (1) the exportation of such substances from the United States in conformity with subchapter II of this chapter;
- (2) the delivery of such a substance to or by a common or contract carrier for carriage in the lawful and usual course of its business, or to or by a warehouseman for storage in the lawful and usual course of its business; but where such carriage or storage is in connection with the distribution by the owner of the substance to a third person, this paragraph shall not relieve the distributor from compliance with subsection (a) of this section.

- **(c) Preservation and availability**
  - (1) Every person who in pursuance of an order required under subsection (a) of this section distributes a controlled substance shall preserve such order for a period of two years, and shall make such order available for inspection and copying by officers and employees of the United States duly authorized for that purpose by the Attorney General, and by officers or employees of States or their political subdivisions who are charged with the enforcement of State or local laws regulating the production, or regulating the distribution or dispensing, of controlled substances and who are authorized under such laws to inspect such orders.
  - (2) Every person who gives an order required under subsection (a) of this section shall, at or before the time of giving such order, make or cause to be made a duplicate thereof on a form to be issued by the Attorney General in blank in accordance with subsection (d) of this section and regulations prescribed by him pursuant to this section, and shall, if such order is accepted, preserve such duplicate for a period of two years and make it available for inspection and copying by the officers and employees mentioned in paragraph (1) of this subsection.

- **(d) Issuance**
  - (1) The Attorney General shall issue forms pursuant to subsections (a) and (c)(2) of this section only to persons validly registered under section 823 of this title (or exempted from registration under section 822(d) of this title). Whenever any such form is issued to a person, the Attorney General shall, before delivery thereof, insert therein the name of such person, and it shall be unlawful for any other person (A) to use such form for the purpose of obtaining controlled substances or (B) to furnish such form to

any person with intent thereby to procure the distribution of such substances.

- (2) The Attorney General may charge reasonable fees for the issuance of such forms in such amounts as he may prescribe for the purpose of covering the cost to the United States of issuing such forms, and other necessary activities in connection therewith.

- **(e) Unlawful acts**

It shall be unlawful for any person to obtain by means of order forms issued under this section controlled substances for any purpose other than their use, distribution, dispensing, or administration in the conduct of a lawful business in such substances or in the course of his professional practice or research.

§ 829. Prescriptions.

- **(a) Schedule II substances**

Except when dispensed directly by a practitioner, other than a pharmacist, to an ultimate user, no controlled substance in schedule II, which is a prescription drug as determined under the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 301 et seq.), may be dispensed without the written prescription of a practitioner, except that in emergency situations, as prescribed by the Secretary by regulation after consultation with the Attorney General, such drug may be dispensed upon oral prescription in accordance with section 503(b) of that Act (21 U.S.C. 353(b)). Prescriptions shall be retained in conformity with the requirements of section 827 of this title. No prescription for a controlled substance in schedule II may be refilled.

- **(b) Schedule III and IV substances**

Except when dispensed directly by a practitioner, other than a pharmacist, to an ultimate user, no controlled substance in schedule III or IV, which is a prescription drug as determined under the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 301 et seq.), may be dispensed without a written or oral prescription in conformity with section 503(b) of that Act (21 U.S.C. 353(b)). Such prescriptions may not be filled or refilled more than six months after the date thereof or be refilled more than five times after the date of the prescription unless renewed by the practitioner.

- **(c) Schedule V substances**

No controlled substance in schedule V which is a drug may be distributed or dispensed other than for a medical purpose.

- **(d) Non-prescription drugs with abuse potential**

Whenever it appears to the Attorney General that a drug not considered to be a prescription drug under the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 301 et seq.) should be so considered because of its abuse potential, he shall so advise the Secretary and furnish to him all available data relevant thereto.

§ 830. Regulation of listed chemicals and certain machines.

- **(a) Record of regulated transactions**
  - (1) Each regulated person who engages in a regulated transaction involving a listed chemical, a tableting machine, or an encapsulating machine shall keep a record of the transaction -
    - (A) for 4 years after the date of the transaction, if the listed chemical is a list I chemical or if the transaction involves a tableting machine or an encapsulating machine; and
    - (B) for 2 years after the date of the transaction, if the listed chemical is a list II chemical.
  - (2) A record under this subsection shall be retrievable and shall include the date of the regulated transaction, the identity of each party to the regulated transaction, a statement of the quantity and form of the listed chemical, a description of the tableting machine or encapsulating machine, and a description of the method of transfer. Such record shall be available for inspection and copying by the Attorney General.
  - (3) It is the duty of each regulated person who engages in a regulated transaction to identify each other party to the transaction. It is the duty of such other party to present proof of identity to the regulated person. The Attorney General shall specify by regulation the types of documents and other evidence that constitute proof of identity for purposes of this paragraph.

- **(b) Reports to Attorney General**
  - (1) Each regulated person shall report to the Attorney General, in such form and manner as the Attorney General shall prescribe by regulation -
    - (A) any regulated transaction involving an extraordinary quantity of a listed chemical, an uncommon method of payment or delivery, or any other circumstance that the regulated person believes may indicate that the listed chemical will be used in violation of this subchapter;
    - (B) any proposed regulated transaction with a person whose description or other identifying characteristic the Attorney General furnishes in advance to the regulated person;
    - (C) any unusual or excessive loss or disappearance of a listed chemical under the control of the regulated person; and
    - (D) any regulated transaction in a tableting machine or an encapsulating machine.

Each report under subparagraph (A) shall be made at the earliest practicable opportunity after the regulated person becomes aware of the circumstance involved. A regulated person may not complete a transaction with a person whose description or identifying characteristic is furnished to the regulated person under subparagraph (B) unless the transaction is approved by the Attorney General. The Attorney General shall make available to regulated persons guidance documents describing transactions and circumstances for which reports are required under subparagraph (A) and subparagraph (C).

- (2) A regulated person that manufactures a listed chemical shall report annually to the Attorney General, in such form and manner and containing such specific data as the Attorney General shall prescribe by regulation, information concerning listed chemicals manufactured by the person. The requirement of the preceding sentence shall not apply to the manufacture of a drug product that is exempted under section 802(39)(A)(iv) of this title.

- **(c) Confidentiality of information obtained by Attorney General; non-disclosure; exceptions**
  - (1) Except as provided in paragraph (2), any information obtained by the Attorney General under this section which is exempt from disclosure under section 552(a) of title 5, by reason of section 552(b)(4) of such title, is confidential and may not be disclosed to any person.
  - (2) Information referred to in paragraph (1) may be disclosed only -
    - (A) to an officer or employee of the United States engaged in carrying out this subchapter, subchapter II of this chapter, or the customs laws;
    - (B) when relevant in any investigation or proceeding for the enforcement of this subchapter, subchapter II of this chapter, or the customs laws;
    - (C) when necessary to comply with an obligation of the United States under a treaty or other international agreement; or
    - (D) to a State or local official or employee in conjunction with the enforcement of controlled substances laws or chemical control laws.
  - (3) The Attorney General shall -
    - (A) take such action as may be necessary to prevent unauthorized disclosure of information by any person to whom such information is disclosed under paragraph (2); and
    - (B) issue guidelines that limit, to the maximum extent feasible, the disclosure of proprietary business information, including the names or identities of United States exporters of listed chemicals, to any person to whom such information is disclosed under paragraph (2).

- (4) Any person who is aggrieved by a disclosure of information in violation of this section may bring a civil action against the violator for appropriate relief.
- (5) Notwithstanding paragraph (4), a civil action may not be brought under such paragraph against investigative or law enforcement personnel of the Drug Enforcement Administration.

PART D - OFFENSES AND PENALTIES

§ 841. Prohibited acts A.

- **(a) Unlawful acts**

Except as authorized by this subchapter, it shall be unlawful for any person knowingly or intentionally -

- (1) to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance; or
- (2) to create, distribute, or dispense, or possess with intent to distribute or dispense, a counterfeit substance.

- **(b) Penalties**

Except as otherwise provided in section 849, 859, 860, or 861 of this title, any person who violates subsection (a) of this section shall be sentenced as follows:

- (1)
  - (A) In the case of a violation of subsection (a) of this section involving -
    - (i) 1 kilogram or more of a mixture or substance containing a detectable amount of heroin;
    - (ii) 5 kilograms or more of a mixture or substance containing a detectable amount of -
      - (I) coca leaves, except coca leaves and extracts of coca leaves from which cocaine, ecgonine, and derivatives of ecgonine or their salts have been removed;
      - (II) cocaine, its salts, optical and geometric isomers, and salts of isomers;
      - (III) ecgonine, its derivatives, their salts, isomers, and salts of isomers; or

        - (IV) any compound, mixture, or preparation which contains any quantity of any of the substances referred to in subclauses (I) through (III);
    - (iii) 50 grams or more of a mixture or substance described in clause (ii) which contains cocaine base;
    - (iv) 100 grams or more of phencyclidine (PCP) or 1 kilogram or more of a mixture or substance containing a detectable amount of phencyclidine (PCP);
    - (v) 10 grams or more of a mixture or substance containing a detectable amount of lysergic acid diethylamide (LSD);
    - (vi) 400 grams or more of a mixture or substance containing a detectable amount of N-phenyl-N- (1- (2-phenylethyl) -4-piperidinyl) propanamide or 100 grams or more of a mixture or substance containing a detectable amount of any analogue of N-pheny propanamide;
    - (vii) 1000 kilograms or more of a mixture or substance containing a detectable amount of marihuana, or 1,000 or more marihuana plants regardless of weight; or
    - (viii) 100 grams or more of methamphetamine, its salts, isomers, and salts of its isomers or 1 kilogram or more of a mixture or substance containing a detectable amount of methamphetamine, its salts, isomers, or salts of its isomers;

such person shall be sentenced to a term of imprisonment which may not be less than 10 years or more than life and if death or serious bodily injury results from the use of such substance shall be not less than 20 years or more than life, a fine not to exceed the greater of that authorized in accordance with the provisions of title 18 or $4,000,000 if the defendant is an individual or $10,000,000 if the defendant is other than an individual, or both. If any person commits such a violation after a prior conviction for a felony drug offense has become final, such person shall be sentenced to a term of imprisonment which may not be less than 20 years and not more than life imprisonment and if death or serious bodily injury results from the use of such substance shall be sentenced to life imprisonment, a fine not to exceed the greater of twice that authorized in accordance with the provisions of title 18 or $8,000,000 if the defendant is an individual or $20,000,000 if the defendant is other than an individual, or both. If any person commits a violation of this subparagraph or of section 849, 859, 860, or 861 of this title after two or more prior convictions for a felony drug offense have become final, such person shall be sentenced to a mandatory term of life imprisonment without release and fined in accordance with the preceding sentence. Any sentence under this subparagraph shall, in the absence of such a prior conviction, impose a term of supervised release of at least 5 years in addition to such term of

imprisonment and shall, if there was such a prior conviction, impose a term of supervised release of at least 10 years in addition to such term of imprisonment. Notwithstanding any other provision of law, the court shall not place on probation or suspend the sentence of any person sentenced under this subparagraph. No person sentenced under this subparagraph shall be eligible for parole during the term of imprisonment imposed therein.

- (B) In the case of a violation of subsection (a) of this section involving -
  - (i) 100 grams or more of a mixture or substance containing a detectable amount of heroin;
  - (ii) 500 grams or more of a mixture or substance containing a detectable amount of -
    - (I) coca leaves, except coca leaves and extracts of coca leaves from which cocaine, ecgonine, and derivatives of ecgonine or their salts have been removed;
    - (II) cocaine, its salts, optical and geometric isomers, and salts of isomers;
    - (III) ecgonine, its derivatives, their salts, isomers, and salts of isomers; or
    - (IV) any compound, mixture, or preparation which contains any quantity of any of the substances referred to in subclauses (I) through (III);
  - (iii) 5 grams or more of a mixture or substance described in clause (ii) which contains cocaine base;
  - (iv) 10 grams or more of phencyclidine (PCP) or 100 grams or more of a mixture or substance containing a detectable amount of phencyclidine (PCP);
  - (v) 1 gram or more of a mixture or substance containing a detectable amount of lysergic acid diethylamide (LSD);
  - (vi) 40 grams or more of a mixture or substance containing a detectable amount of N-phenyl-N- (1- (2-phenylethyl) -4-piperidinyl) propanamide or 10 grams or more of a mixture or substance containing a detectable amount of any analogue of N-pheny propanamide;
  - (vii) 100 kilograms or more of a mixture or substance containing a detectable amount of marihuana, or 100 or more marihuana plants regardless of weight; or
  - (viii) 10 grams or more of methamphetamine, its salts, isomers, and salts of its isomers or 100 grams or more of a mixture or substance containing a detectable amount of methamphetamine, its salts, isomers, or salts of its isomers;

such person shall be sentenced to a term of imprisonment which may not be less than 5 years and not more than 40 years and if death or serious bodily injury results from the use of such substance shall be not less than

20 years or more than life, a fine not to exceed the greater of that authorized in accordance with the provisions of title 18 or $2,000,000 if the defendant is an individual or $5,000,000 if the defendant is other than an individual, or both. If any person commits such a violation after a prior conviction for a felony drug offense has become final, such person shall be sentenced to a term of imprisonment which may not be less than 10 years and not more than life imprisonment and if death or serious bodily injury results from the use of such substance shall be sentenced to life imprisonment, a fine not to exceed the greater of twice that authorized in accordance with the provisions of title 18 or $4,000,000 if the defendant is an individual or $10,000,000 if the defendant is other than an individual, or both. Any sentence imposed under this subparagraph shall, in the absence of such a prior conviction, include a term of supervised release of at least 4 years in addition to such term of imprisonment and shall, if there was such a prior conviction, include a term of supervised release of at least 8 years in addition to such term of imprisonment. Notwithstanding any other provision of law, the court shall not place on probation or suspend the sentence of any person sentenced under this subparagraph. No person sentenced under this subparagraph shall be eligible for parole during the term of imprisonment imposed therein.

- (C) In the case of a controlled substance in schedule I or II except as provided in subparagraphs (A), (B), and (D), such person shall be sentenced to a term of imprisonment of not more than 20 years and if death or serious bodily injury results from the use of such substance shall be sentenced to a term of imprisonment of not less than twenty years or more than life, a fine not to exceed the greater of that authorized in accordance with the provisions of title 18 or $1,000,000 if the defendant is an individual or $5,000,000 if the defendant is other than an individual, or both. If any person commits such a violation after a prior conviction for a felony drug offense has become final, such person shall be sentenced to a term of imprisonment of not more than 30 years and if death or serious bodily injury results from the use of such substance shall be sentenced to life imprisonment, a fine not to exceed the greater of twice that authorized in accordance with the provisions of title 18 or $2,000,000 if the defendant is an individual or $10,000,000 if the defendant is other than an individual, or both. Any sentence imposing a term of imprisonment under this paragraph shall, in the absence of such a prior conviction, impose a term of supervised release of at least 3 years in addition to such term of imprisonment and shall, if there was such a prior conviction, impose a term of supervised release of at least 6 years in addition to such term of imprisonment. Notwithstanding any other provision of law, the court shall

not place on probation or suspend the sentence of any person sentenced under the provisions of this subparagraph which provide for a mandatory term of imprisonment if death or serious bodily injury results, nor shall a person so sentenced be eligible for parole during the term of such a sentence.

- (D) In the case of less than 50 kilograms of marihuana, except in the case of 50 or more marihuana plants regardless of weight, 10 kilograms of hashish, or one kilogram of hashish oil or in the case of any controlled substance in schedule III, such person shall, except as provided in paragraphs (4) and (5) of this subsection, be sentenced to a term of imprisonment of not more than 5 years, a fine not to exceed the greater of that authorized in accordance with the provisions of title 18 or $250,000 if the defendant is an individual or $1,000,000 if the defendant is other than an individual, or both. If any person commits such a violation after a prior conviction for a felony drug offense has become final, such person shall be sentenced to a term of imprisonment of not more than 10 years, a fine not to exceed the greater of twice that authorized in accordance with the provisions of title 18 or $500,000 if the defendant is an individual or $2,000,000 if the defendant is other than an individual, or both. Any sentence imposing a term of imprisonment under this paragraph shall, in the absence of such a prior conviction, impose a term of supervised release of at least 2 years in addition to such term of imprisonment and shall, if there was such a prior conviction, impose a term of supervised release of at least 4 years in addition to such term of imprisonment.

- (2) In the case of a controlled substance in schedule IV, such person shall be sentenced to a term of imprisonment of not more than 3 years, a fine not to exceed the greater of that authorized in accordance with the provisions of title 18 or $250,000 if the defendant is an individual or $1,000,000 if the defendant is other than an individual, or both. If any person commits such a violation after one or more prior convictions of him for an offense punishable under this paragraph, or for a felony under any other provision of this subchapter or subchapter II of this chapter or other law of a State, the United States, or a foreign country relating to narcotic drugs, marihuana, or depressant or stimulant substances, have become final, such person shall be sentenced to a term of imprisonment of not more than 6 years, a fine not to exceed the greater of twice that authorized in accordance with the provisions of title 18 or $500,000 if the defendant is an individual or $2,000,000 if the defendant is other than an individual, or both. Any sentence imposing a term of imprisonment under this paragraph shall, in the absence of such a prior conviction, impose a term of supervised release of at least one year in addition to such term of imprisonment and shall, if there was such a prior conviction, impose a term of supervised release of at least 2 years in addition to such term of imprisonment.
- (3) In the case of a controlled substance in schedule V, such person shall be sentenced to a term of imprisonment of not more than one year, a fine not to exceed the greater of that authorized in accordance with the provisions of title 18 or $100,000 if the defendant is an individual or $250,000 if the defendant is other

than an individual, or both. If any person commits such a violation after one or more convictions of him for an offense punishable under this paragraph, or for a crime under any other provision of this subchapter or subchapter II of this chapter or other law of a State, the United States, or a foreign country relating to narcotic drugs, marihuana, or depressant or stimulant substances, have become final, such person shall be sentenced to a term of imprisonment of not more than 2 years, a fine not to exceed the greater of twice that authorized in accordance with the provisions of title 18 or $200,000 if the defendant is an individual or $500,000 if the defendant is other than an individual, or both.

- (4) Notwithstanding paragraph (1)(D) of this subsection, any person who violates subsection (a) of this section by distributing a small amount of marihuana for no remuneration shall be treated as provided in section 844 of this title and section 3607 of title 18.
- (5) Any person who violates subsection (a) of this section by cultivating a controlled substance on Federal property shall be imprisoned as provided in this subsection and shall be fined any amount not to exceed -
    - (A) the amount authorized in accordance with this section;
    - (B) the amount authorized in accordance with the provisions of title 18;
    - (C) $500,000 if the defendant is an individual; or
    - (D) $1,000,000 if the defendant is other than an individual; or both.
- (6) Any person who violates subsection (a) of this section, or attempts to do so, and knowingly or intentionally uses a poison, chemical, or other hazardous substance on Federal land, and, by such use -
    - (A) creates a serious hazard to humans, wildlife, or domestic animals,
    - (B) degrades or harms the environment or natural resources, or
    - (C) pollutes an aquifer, spring, stream, river, or body of water, shall be fined in accordance with title 18 or imprisoned not more than five years, or both.

- **(c) Repealed. Pub. L. 98-473, title II, Sec. 224(a)(2), formerly Sec. 224(a)(6), Oct. 12, 1984, 98 Stat. 2030, as renumbered by Pub. L. 99-570, title I, Sec. 1005(a)(2), Oct. 27, 1986, 100 Stat. 3207-6**

- **(d) Offenses involving listed chemicals**

Any person who knowingly or intentionally -

- (1) possesses a listed chemical with intent to manufacture a controlled substance except as authorized by this subchapter;
- (2) possesses or distributes a listed chemical knowing, or having reasonable cause to believe, that the listed chemical will be used to manufacture a controlled substance except as authorized by this subchapter; or
- (3) with the intent of causing the evasion of the recordkeeping or reporting requirements of section 830 of this title, or the regulations issued under that section, receives or distributes a reportable amount of any listed chemical in units small enough so that the making of records or filing of reports under that section

is not required; shall be fined in accordance with title 18 or imprisoned not more than 10 years, or both.

- **(e) Boobytraps on Federal property; penalties; ''boobytrap'' defined**
  - (1) Any person who assembles, maintains, places, or causes to be placed a boobytrap on Federal property where a controlled substance is being manufactured, distributed, or dispensed shall be sentenced to a term of imprisonment for not more than 10 years and shall be fined not more than $10,000.
  - (2) If any person commits such a violation after 1 or more prior convictions for an offense punishable under this subsection, such person shall be sentenced to a term of imprisonment of not more than 20 years and shall be fined not more than $20,000.
  - (3) For the purposes of this subsection, the term "boobytrap" means any concealed or camouflaged device designed to cause bodily injury when triggered by any action of any unsuspecting person making contact with the device. Such term includes guns, ammunition, or explosive devices attached to trip wires or other triggering mechanisms, sharpened stakes, and lines or wires with hooks attached.

- **(f) Ten-year injunction as additional penalty**

In addition to any other applicable penalty, any person convicted of a felony violation of this section relating to the receipt, distribution, or importation of a listed chemical may be enjoined from engaging in any regulated transaction involving a listed chemical for not more than ten years.

- **(g) Wrongful distribution or possession of listed chemicals**
  - (1) Whoever knowingly distributes a listed chemical in violation of this subchapter (other than in violation of a recordkeeping or reporting requirement of section 830 of this title) shall be fined under title 18 or imprisoned not more than 5 years, or both.
  - (2) Whoever possesses any listed chemical, with knowledge that the recordkeeping or reporting requirements of section 830 of this title have not been adhered to, if, after such knowledge is acquired, such person does not take immediate steps to remedy the violation shall be fined under title 18 or imprisoned not more than one year, or both.

§ 842. Prohibited acts B.

- **(a) Unlawful acts**

It shall be unlawful for any person -

- (1) who is subject to the requirements of part C to distribute or dispense a controlled substance in violation of section 829 of this title;

- (2) who is a registrant to distribute or dispense a controlled substance not authorized by his registration to another registrant or other authorized person or to manufacture a controlled substance not authorized by his registration;
- (3) who is a registrant to distribute a controlled substance in violation of section 825 of this title;
- (4) to remove, alter, or obliterate a symbol or label required by section 825 of this title;
- (5) to refuse or fail to make, keep, or furnish any record, report, notification, declaration, order or order form, statement, invoice, or information required under this subchapter or subchapter II of this chapter;
- (6) to refuse any entry into any premises or inspection authorized by this subchapter or subchapter II of this chapter;
- (7) to remove, break, injure, or deface a seal placed upon controlled substances pursuant to section 824(f) or 881 of this title or to remove or dispose of substances so placed under seal;
- (8) to use, to his own advantage, or to reveal, other than to duly authorized officers or employees of the United States, or to the courts when relevant in any judicial proceeding under this subchapter or subchapter II of this chapter, any information acquired in the course of an inspection authorized by this subchapter concerning any method or process which as a trade secret is entitled to protection, or to use to his own advantage or reveal (other than as authorized by section 830 of this title) any information that is confidential under such section;
- (9) who is a regulated person to engage in a regulated transaction without obtaining the identification required by 830(a)(3) of this title; or
- (10) to fail to keep a record or make a report under section 830 of this title.

- **(b) Manufacture**

It shall be unlawful for any person who is a registrant to manufacture a controlled substance in schedule I or II which is -

- (1) not expressly authorized by his registration and by a quota assigned to him pursuant to section 826 of this title; or
- (2) in excess of a quota assigned to him pursuant to section 826 of this title.

- **(c) Penalties**
    - (1) Except as provided in paragraph (2), any person who violates this section shall, with respect to any such violation, be subject to a civil penalty of not more than $25,000. The district courts of the United States (or, where there is no such court in the case of any territory or possession of the United States, then the court in such territory or possession having the jurisdiction of a district court of the United States in cases arising under the Constitution and laws of the United States) shall have jurisdiction in accordance with section 1355 of title 28 to enforce this paragraph.
    - (2)

        - (A) If a violation of this section is prosecuted by an information or indictment which alleges that the violation was committed knowingly and the trier of fact specifically finds that the violation was so committed, such person shall, except as otherwise provided in subparagraph (B) of this paragraph, be sentenced to imprisonment of not more than one year or a fine of not more than $25,000, or both.
        - (B) If a violation referred to in subparagraph (A) was committed after one or more prior convictions of the offender for an offense punishable under this paragraph (2), or for a crime under any other provision of this subchapter or subchapter II of this chapter or other law of the United States relating to narcotic drugs, marihuana, or depressant or stimulant substances, have become final, such person shall be sentenced to a term of imprisonment of not more than 2 years, a fine of $50,000, or both.
    - (3) Except under the conditions specified in paragraph (2) of this subsection, a violation of this section does not constitute a crime, and a judgment for the United States and imposition of a civil penalty pursuant to paragraph (1) shall not give rise to any disability or legal disadvantage based on conviction for a criminal offense.

§ 843. Prohibited acts C.

- **(a) Unlawful acts**

It shall be unlawful for any person knowingly or intentionally -

- (1) who is a registrant to distribute a controlled substance classified in schedule I or II, in the course of his legitimate business, except pursuant to an order or an order form as required by section 828 of this title;
- (2) to use in the course of the manufacture, distribution, or dispensing of a controlled substance, or to use for the purpose of acquiring or obtaining a controlled substance, a registration number which is fictitious, revoked, suspended, expired, or issued to another person;
- (3) to acquire or obtain possession of a controlled substance by misrepresentation, fraud, forgery, deception, or subterfuge;
- (4)
    - (A) to furnish false or fraudulent material information in, or omit any material information from, any application, report, record, or other document required to be made, kept, or filed under this subchapter or subchapter II of this chapter, or
    - (B) to present false or fraudulent identification where the person is receiving or purchasing a listed chemical and the person is required to present identification under section 830(a) of this title;
- (5) to make, distribute, or possess any punch, die, plate, stone, or other thing designed to print, imprint, or reproduce the trademark, trade name, or other

identifying mark, imprint, or device of another or any likeness of any of the foregoing upon any drug or container or labeling thereof so as to render such drug a counterfeit substance;

- (6) to possess any three-neck round-bottom flask, tableting machine, encapsulating machine, or gelatin capsule, or any equipment, chemical, product, or material which may be used to manufacture a controlled substance or listed chemical, knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance or listed chemical in violation of this subchapter or subchapter II of this chapter;
- (7) to manufacture, distribute, export, or import any three-neck round-bottom flask, tableting machine, encapsulating machine, or gelatin capsule, or any equipment, chemical, product, or material which may be used to manufacture a controlled substance or listed chemical, knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance or listed chemical in violation of this subchapter or subchapter II of this chapter or, in the case of an exportation, in violation of this subchapter or subchapter II of this chapter or of the laws of the country to which it is exported;
- (8) to create a chemical mixture for the purpose of evading a requirement of section 830 of this title or to receive a chemical mixture created for that purpose; or
- (9) to distribute, import, or export a list I chemical without the registration required by this subchapter or subchapter II of this chapter.

- **(b) Communication facility**

It shall be unlawful for any person knowingly or intentionally to use any communication facility in committing or in causing or facilitating the commission of any act or acts constituting a felony under any provision of this subchapter or subchapter II of this chapter. Each separate use of a communication facility shall be a separate offense under this subsection. For purposes of this subsection, the term "communication facility" means any and all public and private instrumentalities used or useful in the transmission of writing, signs, signals, pictures, or sounds of all kinds and includes mail, telephone, wire, radio, and all other means of communication.

- **(c) Advertisement**

It shall be unlawful for any person to place in any newspaper, magazine, handbill, or other publications, any written advertisement knowing that it has the purpose of seeking or offering illegally to receive, buy, or distribute a Schedule (FOOTNOTE 1) I controlled substance. As used in this section the term "advertisement" includes, in addition to its ordinary meaning, such advertisements as those for a catalog of Schedule (FOOTNOTE 1) I controlled substances and any similar written advertisement that has the purpose of seeking or offering illegally to receive, buy, or distribute a Schedule (FOOTNOTE 1) I controlled substance. The term "advertisement" does not include material which merely advocates the use of a similar material, which advocates a position or practice, and does

not attempt to propose or facilitate an actual transaction in a Schedule (FOOTNOTE 1) I controlled substance. (FOOTNOTE 1) So in original. Probably should not be capitalized.

- **(d) Penalties**

Any person who violates this section shall be sentenced to a term of imprisonment of not more than 4 years, a fine of not more than $30,000, or both; except that if any person commits such a violation after one or more prior convictions of him for violation of this section, or for a felony under any other provision of this subchapter or subchapter II of this chapter or other law of the United States relating to narcotic drugs, marihuana, or depressant or stimulant substances, have become final, such person shall be sentenced to a term of imprisonment of not more than 8 years, a fine of not more than $60,000, or both.

- **(e) Additional penalties**

In addition to any other applicable penalty, any person convicted of a felony violation of this section relating to the receipt, distribution, or importation of a listed chemical may be enjoined from engaging in any regulated transaction involving a listed chemical for not more than ten years.

§ 844. Penalties for simple possession.

- **(a) Unlawful acts; penalties**

It shall be unlawful for any person knowingly or intentionally to possess a controlled substance unless such substance was obtained directly, or pursuant to a valid prescription or order, from a practitioner, while acting in the course of his professional practice, or except as otherwise authorized by this subchapter or subchapter II of this chapter. Any person who violates this subsection may be sentenced to a term of imprisonment of not more than 1 year, and shall be fined a minimum of $1,000, or both, except that if he commits such offense after a prior conviction under this subchapter or subchapter II of this chapter, or a prior conviction for any drug or narcotic offense chargeable under the law of any State, has become final, he shall be sentenced to a term of imprisonment for not less than 15 days but not more than 2 years, and shall be fined a minimum of $2,500, except, further, that if he commits such offense after two or more prior convictions under this subchapter or subchapter II of this chapter, or two or more prior convictions for any drug or narcotic offense chargeable under the law of any State, or a combination of two or more such offenses have become final, he shall be sentenced to a term of imprisonment for not less than 90 days but not more than 3 years, and shall be fined a minimum of $5,000. Notwithstanding the preceding sentence, a person convicted under this subsection for the possession of a mixture or substance which contains cocaine base shall be imprisoned not less than 5 years and not more than 20 years, and fined a minimum of $1,000, if the conviction is a first conviction under this subsection and the amount of the mixture or substance exceeds 5 grams, if the conviction is after a prior conviction for the possession of such a mixture or substance under this subsection

becomes final and the amount of the mixture or substance exceeds 3 grams, or if the conviction is after 2 or more prior convictions for the possession of such a mixture or substance under this subsection become final and the amount of the mixture or substance exceeds 1 gram. The imposition or execution of a minimum sentence required to be imposed under this subsection shall not be suspended or deferred. Further, upon conviction, a person who violates this subsection shall be fined the reasonable costs of the investigation and prosecution of the offense, including the costs of prosecution of an offense as defined in sections 1918 and 1920 of title 28, except that this sentence shall not apply and a fine under this section need not be imposed if the court determines under the provision of title 18 that the defendant lacks the ability to pay.

- **(b) Repealed. Pub. L. 98-473, title II, Sec. 219(a), Oct. 12, 1984, 98 Stat. 2027**

- **(c) ''Drug or narcotic offense'' defined**

As used in this section, the term "drug or narcotic offense" means any offense which proscribes the possession, distribution, manufacture, cultivation, sale, transfer, or the attempt or conspiracy to possess, distribute, manufacture, cultivate, sell or transfer any substance the possession of which is prohibited under this subchapter.

§ 844a. Civil penalty for possession of small amounts of certain controlled substances.

- **(a) In general**

Any individual who knowingly possesses a controlled substance that is listed in section 841(b)(1)(A) of this title in violation of section 844 of this title in an amount that, as specified by regulation of the Attorney General, is a personal use amount shall be liable to the United States for a civil penalty in an amount not to exceed $10,000 for each such violation.

- **(b) Income and net assets**

The income and net assets of an individual shall not be relevant to the determination whether to assess a civil penalty under this section or to prosecute the individual criminally. However, in determining the amount of a penalty under this section, the income and net assets of an individual shall be considered.

- **(c) Prior conviction**

A civil penalty may not be assessed under this section if the individual previously was convicted of a Federal or State offense relating to a controlled substance.

- **(d) Limitation on number of assessments**

A civil penalty may not be assessed on an individual under this section on more than two separate occasions.

- **(e) Assessment**

A civil penalty under this section may be assessed by the Attorney General only by an order made on the record after opportunity for a hearing in accordance with section 554 of title 5. The Attorney General shall provide written notice to the individual who is the subject of the proposed order informing the individual of the opportunity to receive such a hearing with respect to the proposed order. The hearing may be held only if the individual makes a request for the hearing before the expiration of the 30-day period beginning on the date such notice is issued.

- **(f) Compromise**

The Attorney General may compromise, modify, or remit, with or without conditions, any civil penalty imposed under this section.

- **(g) Judicial review**

If the Attorney General issues an order pursuant to subsection (e) of this section after a hearing described in such subsection, the individual who is the subject of the order may, before the expiration of the 30-day period beginning on the date the order is issued, bring a civil action in the appropriate district court of the United States. In such action, the law and the facts of the violation and the assessment of the civil penalty shall be determined de novo, and shall include the right of a trial by jury, the right to counsel, and the right to confront witnesses. The facts of the violation shall be proved beyond a reasonable doubt.

- **(h) Civil action**

If an individual does not request a hearing pursuant to subsection (e) of this section and the Attorney General issues an order pursuant to such subsection, or if an individual does not under subsection (g) of this section seek judicial review of such an order, the Attorney General may commence a civil action in any appropriate district court of the United States for the purpose of recovering the amount assessed and an amount representing interest at a rate computed in accordance with section 1961 of title 28. Such interest shall accrue from the expiration of the 30-day period described in subsection (g) of this section. In such an action, the decision of the Attorney General to issue the order, and the amount of the penalty assessed by the Attorney General, shall not be subject to review.

- **(i) Limitation**

The Attorney General may not under this subsection (FOOTNOTE 1) commence proceeding against an individual after the expiration of the 5-year period beginning on

the date on which the individual allegedly violated subsection (a) of this section. (FOOTNOTE 1) So in original. Probably should be "section".

- **(j) Expungement procedures**

The Attorney General shall dismiss the proceedings under this section against an individual upon application of such individual at any time after the expiration of 3 years if -

- (1) the individual has not previously been assessed a civil penalty under this section;
- (2) the individual has paid the assessment;
- (3) the individual has complied with any conditions imposed by the Attorney General;
- (4) the individual has not been convicted of a Federal or State offense relating to a controlled substance; and
- (5) the individual agrees to submit to a drug test, and such test shows the individual to be drug free.

A nonpublic record of a disposition under this subsection shall be retained by the Department of Justice solely for the purpose of determining in any subsequent proceeding whether the person qualified for a civil penalty or expungement under this section. If a record is expunged under this subsection, an individual concerning whom such an expungement has been made shall not be held thereafter under any provision of law to be guilty of perjury, false swearing, or making a false statement by reason of his failure to recite or acknowledge a proceeding under this section or the results thereof in response to an inquiry made of him for any purpose.

§ 845 to 845b. Transferred.

§ 846. Attempt and conspiracy.

Any person who attempts or conspires to commit any offense defined in this subchapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.

§ 847. Additional penalties.

Any penalty imposed for violation of this subchapter shall be in addition to, and not in lieu of, any civil or administrative penalty or sanction authorized by law.

§ 848. Continuing criminal enterprise.

- **(a) Penalties; forfeitures**

Any person who engages in a continuing criminal enterprise shall be sentenced to a term of imprisonment which may not be less than 20 years and which may be up to life imprisonment, to a fine not to exceed the greater of that authorized in accordance with the provisions of title 18 or $2,000,000 if the defendant is an individual or $5,000,000 if the defendant is other than an individual, and to the forfeiture prescribed in section 853 of this title; except that if any person engages in such activity after one or more prior convictions of him under this section have become final, he shall be sentenced to a term of imprisonment which may not be less than 30 years and which may be up to life imprisonment, to a fine not to exceed the greater of twice the amount authorized in accordance with the provisions of title 18 or $4,000,000 if the defendant is an individual or $10,000,000 if the defendant is other than an individual, and to the forfeiture prescribed in section 853 of this title.

- **(b) Life imprisonment for engaging in continuing criminal enterprise**

Any person who engages in a continuing criminal enterprise shall be imprisoned for life and fined in accordance with subsection (a) of this section, if -

- (1) such person is the principal administrator, organizer, or leader of the enterprise or is one of several such principal administrators, organizers, or leaders; and
- (2)
    - (A) the violation referred to in subsection (c)(1) of this section involved at least 300 times the quantity of a substance described in subsection 841(b)(1)(B) of this title, or
    - (B) the enterprise, or any other enterprise in which the defendant was the principal or one of several principal administrators, organizers, or leaders, received $10 million dollars in gross receipts during any twelve-month period of its existence for the manufacture, importation, or distribution of a substance described in section 841(b)(1)(B) of this title.

- **(c) ''Continuing criminal enterprise'' defined**

For purposes of subsection (a) of this section, a person is engaged in a continuing criminal enterprise if -

- (1) he violates any provision of this subchapter or subchapter II of this chapter the punishment for which is a felony, and
- (2) such violation is a part of a continuing series of violations of this subchapter or subchapter II of this chapter -
    - (A) which are undertaken by such person in concert with five or more other persons with respect to whom such person occupies a position of organizer, a supervisory position, or any other position of management, and
    - (B) from which such person obtains substantial income or resources.

- **(d) Suspension of sentence and probation prohibited**

In the case of any sentence imposed under this section, imposition or execution of such sentence shall not be suspended, probation shall not be granted, and the Act of July 15, 1932 (D.C. Code, secs. 24-203 - 24-207), shall not apply.

- **(e) Death penalty**
  - (1) In addition to the other penalties set forth in this section -
    - (A) any person engaging in or working in furtherance of a continuing criminal enterprise, or any person engaging in an offense punishable under section 841(b)(1)(A) of this title or section 960(b)(1) of this title who intentionally kills or counsels, commands, induces, procures, or causes the intentional killing of an individual and such killing results, shall be sentenced to any term of imprisonment, which shall not be less than 20 years, and which may be up to life imprisonment, or may be sentenced to death; and
    - (B) any person, during the commission of, in furtherance of, or while attempting to avoid apprehension, prosecution or service of a prison sentence for, a felony violation of this subchapter or subchapter II of this chapter who intentionally kills or counsels, commands, induces, procures, or causes the intentional killing of any Federal, State, or local law enforcement officer engaged in, or on account of, the performance of such officer's official duties and such killing results, shall be sentenced to any term of imprisonment, which shall not be less than 20 years, and which may be up to life imprisonment, or may be sentenced to death.
  - (2) As used in paragraph (1)(b), (FOOTNOTE 1) the term "law enforcement officer" means a public servant authorized by law or by a Government agency or Congress to conduct or engage in the prevention, investigation, prosecution or adjudication of an offense, and includes those engaged in corrections, probation, or parole functions. (FOOTNOTE 1) So in original. Probably should be paragraph "(1)(B),". (g) (FOOTNOTE 2) Hearing required with respect to death penalty (FOOTNOTE 2) So in original. Section does not contain a subsec.

- **(f), see 1988 Amendment note below.**

- **(g) Hearing required with respect to the death penalty.**

A person shall be subjected to the penalty of death for any offense under this section only if a hearing is held in accordance with this section.

- **(h) Notice by Government in death penalty cases**
  - (1) Whenever the Government intends to seek the death penalty for an offense under this section for which one of the sentences provided is death, the attorney for the Government, a reasonable time before trial or

acceptance by the court of a plea of guilty, shall sign and file with the court, and serve upon the defendant, a notice -

- (A) that the Government in the event of conviction will seek the sentence of death; and
- (B) setting forth the aggravating factors enumerated in subsection (n) of this section and any other aggravating factors which the Government will seek to prove as the basis for the death penalty.

- (2) The court may permit the attorney for the Government to amend this notice for good cause shown.

- **(i) Hearing before court or jury**
  - (1) When the attorney for the Government has filed a notice as required under subsection (h) of this section and the defendant is found guilty of or pleads guilty to an offense under subsection (e) of this section, the judge who presided at the trial or before whom the guilty plea was entered, or any other judge if the judge who presided at the trial or before whom the guilty plea was entered is unavailable, shall conduct a separate sentencing hearing to determine the punishment to be imposed. The hearing shall be conducted -
    - (A) before the jury which determined the defendant's guilt;
    - (B) before a jury impaneled for the purpose of the hearing if -
      - (i) the defendant was convicted upon a plea of guilty;
      - (ii) the defendant was convicted after a trial before the court sitting without a jury;
      - (iii) the jury which determined the defendant's guilt has been discharged for good cause; or
      - (iv) after initial imposition of a sentence under this section, redetermination of the sentence under this section is necessary; or
    - (C) before the court alone, upon the motion of the defendant and with the approval of the Government.
  - (2) A jury impaneled under paragraph (1)(B) shall consist of 12 members, unless, at any time before the conclusion of the hearing, the parties stipulate with the approval of the court that it shall consist of any number less than 12.

- **(j) Proof of aggravating and mitigating factors**

Notwithstanding rule 32(c) of the Federal Rules of Criminal Procedure, when a defendant is found guilty of or pleads guilty to an offense under subsection (e) of this section, no presentence report shall be prepared. In the sentencing hearing, information may be presented as to matters relating to any of the aggravating or mitigating factors set forth in subsections (m) and (n) of this section, or any other mitigating factor or any other aggravating factor for which notice has been provided under subsection (h)(1)(B) of this section. Where information is presented relating to any of the aggravating factors set forth in subsection (n) of this section, information may be presented relating to any other

aggravating factor for which notice has been provided under subsection (h)(1)(B) of this section. Information presented may include the trial transcript and exhibits if the hearing is held before a jury or judge not present during the trial, or at the trial judge's discretion. Any other information relevant to such mitigating or aggravating factors may be presented by either the Government or the defendant, regardless of its admissibility under the rules governing admission of evidence at criminal trials, except that information may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury. The Government and the defendant shall be permitted to rebut any information received at the hearing and shall be given fair opportunity to present argument as to the adequacy of the information to establish the existence of any of the aggravating or mitigating factors and as to appropriateness in that case of imposing a sentence of death. The Government shall open the argument. The defendant shall be permitted to reply. The Government shall then be permitted to reply in rebuttal. The burden of establishing the existence of any aggravating factor is on the Government, and is not satisfied unless established beyond a reasonable doubt. The burden of establishing the existence of any mitigating factor is on the defendant, and is not satisfied unless established by a preponderance of the evidence.

- **(k) Return of findings**

The jury, or if there is no jury, the court, shall consider all the information received during the hearing. It shall return special findings identifying any aggravating factors set forth in subsection (n) of this section, found to exist. If one of the aggravating factors set forth in subsection (n)(1) of this section and another of the aggravating factors set forth in paragraphs (2) through (12) of subsection (n) of this section is found to exist, a special finding identifying any other aggravating factor for which notice has been provided under subsection (h)(1)(B) of this section, may be returned. A finding with respect to a mitigating factor may be made by one or more of the members of the jury, and any member of the jury who finds the existence of a mitigating factor may consider such a factor established for purposes of this subsection, regardless of the number of jurors who concur that the factor has been established. A finding with respect to any aggravating factor must be unanimous. If an aggravating factor set forth in subsection (n)(1) of this section is not found to exist or an aggravating factor set forth in subsection (n)(1) of this section is found to exist but no other aggravating factor set forth in subsection (n) of this section is found to exist, the court shall impose a sentence, other than death, authorized by law. If an aggravating factor set forth in subsection (n)(1) of this section and one or more of the other aggravating factors set forth in subsection (n) of this section are found to exist, the jury, or if there is no jury, the court, shall then consider whether the aggravating factors found to exist sufficiently outweigh any mitigating factor or factors found to exist, or in the absence of mitigating factors, whether the aggravating factors are themselves sufficient to justify a sentence of death. Based upon this consideration, the jury by unanimous vote, or if there is no jury, the court, shall recommend that a sentence of death shall be imposed rather than a sentence of life imprisonment without possibility of release or some other lesser sentence. The jury or the court, regardless of its findings with respect to aggravating and mitigating factors, is never required to impose a death sentence and the jury shall be so instructed.

- **(l) Imposition of sentence**

Upon the recommendation that the sentence of death be imposed, the court shall sentence the defendant to death. Otherwise the court shall impose a sentence, other than death, authorized by law. A sentence of death shall not be carried out upon a person who is under 18 years of age at the time the crime was committed. A sentence of death shall not be carried out upon a person who is mentally retarded. A sentence of death shall not be carried out upon a person who, as a result of mental disability -

- (1) cannot understand the nature of the pending proceedings, what such person was tried for, the reason for the punishment, or the nature of the punishment; or
- (2) lacks the capacity to recognize or understand facts which would make the punishment unjust or unlawful, or lacks the ability to convey such information to counsel or to the court.

- **(m) Mitigating factors**

In determining whether a sentence of death is to be imposed on a defendant, the finder of fact shall consider mitigating factors, including the following:

- (1) The defendant's capacity to appreciate the wrongfulness of the defendant's conduct or to conform conduct to the requirements of law was significantly impaired, regardless of whether the capacity was so impaired as to constitute a defense to the charge.
- (2) The defendant was under unusual and substantial duress, regardless of whether the duress was of such a degree as to constitute a defense to the charge.
- (3) The defendant is punishable as a principal (as defined in section 2 of title 18) in the offense, which was committed by another, but the defendant's participation was relatively minor, regardless of whether the participation was so minor as to constitute a defense to the charge.
- (4) The defendant could not reasonably have foreseen that the defendant's conduct in the course of the commission of murder, or other offense resulting in death for which the defendant was convicted, would cause, or would create a grave risk of causing, death to any person.
- (5) The defendant was youthful, although not under the age of 18.
- (6) The defendant did not have a significant prior criminal record.
- (7) The defendant committed the offense under severe mental or emotional disturbance.
- (8) Another defendant or defendants, equally culpable in the crime, will not be punished by death.
- (9) The victim consented to the criminal conduct that resulted in the victim's death.
- (10) That other factors in the defendant's background or character mitigate against imposition of the death sentence.

- **(n) Aggravating factors for homicide**

If the defendant is found guilty of or pleads guilty to an offense under subsection (e) of this section, the following aggravating factors are the only aggravating factors that shall be considered, unless notice of additional aggravating factors is provided under subsection (h)(1)(B) of this section:

- (1) The defendant -
  - (A) intentionally killed the victim;
  - (B) intentionally inflicted serious bodily injury which resulted in the death of the victim;
  - (C) intentionally engaged in conduct intending that the victim be killed or that lethal force be employed against the victim, which resulted in the death of the victim;
  - (D) intentionally engaged in conduct which -
    - (i) the defendant knew would create a grave risk of death to a person, other than one of the participants in the offense; and
    - (ii) resulted in the death of the victim.
- (2) The defendant has been convicted of another Federal offense, or a State offense resulting in the death of a person, for which a sentence of life imprisonment or a sentence of death was authorized by statute.
- (3) The defendant has previously been convicted of two or more State or Federal offenses punishable by a term of imprisonment of more than one year, committed on different occasions, involving the infliction of, or attempted infliction of, serious bodily injury upon another person.
- (4) The defendant has previously been convicted of two or more State or Federal offenses punishable by a term of imprisonment of more than one year, committed on different occasions, involving the distribution of a controlled substance.
- (5) In the commission of the offense or in escaping apprehension for a violation of subsection (e) of this section, the defendant knowingly created a grave risk of death to one or more persons in addition to the victims of the offense.
- (6) The defendant procured the commission of the offense by payment, or promise of payment, of anything of pecuniary value.
- (7) The defendant committed the offense as consideration for the receipt, or in the expectation of the receipt, of anything of pecuniary value.
- (8) The defendant committed the offense after substantial planning and premeditation.
- (9) The victim was particularly vulnerable due to old age, youth, or infirmity.
- (10) The defendant had previously been convicted of violating this subchapter or subchapter II of this chapter for which a sentence of five or more years may be imposed or had previously been convicted of engaging in a continuing criminal enterprise.
- (11) The violation of this subchapter in relation to which the conduct described in subsection (e) of this section occurred was a violation of section 859 of this title.
- (12) The defendant committed the offense in an especially heinous, cruel, or depraved manner in that it involved torture or serious physical abuse to the victim.

- **(o) Right of defendant to justice without discrimination**

- (1) In any hearing held before a jury under this section, the court shall instruct the jury that in its consideration of whether the sentence of death is justified it shall not consider the race, color, religious beliefs, national origin, or sex of the defendant or the victim, and that the jury is not to recommend a sentence of death unless it has concluded that it would recommend a sentence of death for the crime in question no matter what the race, color, religious beliefs, national origin, or sex of the defendant, or the victim, may be. The jury shall return to the court a certificate signed by each juror that consideration of the race, color, religious beliefs, national origin, or sex of the defendant or the victim was not involved in reaching his or her individual decision, and that the individual juror would have made the same recommendation regarding a sentence for the crime in question no matter what the race, color, religious beliefs, national origin, or sex of the defendant, or the victim, may be.
- (2) Not later than one year from November 18, 1988, the Comptroller General shall conduct a study of the various procedures used by the several States for determining whether or not to impose the death penalty in particular cases, and shall report to the Congress on whether or not any or all of the various procedures create a significant risk that the race of a defendant, or the race of a victim against whom a crime was committed, influence the likelihood that defendants in those States will be sentenced to death. In conducting the study required by this paragraph, the General Accounting Office shall -
  - (A) use ordinary methods of statistical analysis, including methods comparable to those ruled admissible by the courts in race discrimination cases under title VII of the Civil Rights Act of 1964 (42 U.S.C. 2000e et seq.);
  - (B) study only crimes occurring after January 1, 1976; and
  - (C) determine what, if any, other factors, including any relation between any aggravating or mitigating factors and the race of the victim or the defendant, may account for any evidence that the race of the defendant, or the race of the victim, influences the likelihood that defendants will be sentenced to death. In addition, the General Accounting Office shall examine separately and include in the report, death penalty cases involving crimes similar to those covered under this section.

- **(p) Sentencing in capital cases in which death penalty is not sought or imposed**

If a person is convicted for an offense under subsection (e) of this section and the court does not impose the penalty of death, the court may impose a sentence of life imprisonment without the possibility of parole.

- **(q) Appeal in capital cases; counsel for financially unable defendants**

- (1) In any case in which the sentence of death is imposed under this section, the sentence of death shall be subject to review by the court of appeals upon appeal by the defendant. Notice of appeal must be filed within the time prescribed for appeal of judgment in section 2107 of title 28. An appeal under this section may be consolidated with an appeal of the judgment of conviction. Such review shall have priority over all other cases.
- (2) On review of the sentence, the court of appeals shall consider the record, the evidence submitted during the trial, the information submitted during the sentencing hearing, the procedures employed in the sentencing hearing, and the special findings returned under this section.
- (3) The court shall affirm the sentence if it determines that -
    - (A) the sentence of death was not imposed under the influence of passion, prejudice, or any other arbitrary factor; and
    - (B) the information supports the special finding of the existence of every aggravating factor upon which the sentence was based, together with, or the failure to find, any mitigating factors as set forth or allowed in this section. In all other cases the court shall remand the case for reconsideration under this section. The court of appeals shall state in writing the reasons for its disposition of the review of the sentence.
- (4)
    - (A) Notwithstanding any other provision of law to the contrary, in every criminal action in which a defendant is charged with a crime which may be punishable by death, a defendant who is or becomes financially unable to obtain adequate representation or investigative, expert, or other reasonably necessary services at any time either -
        - (i) before judgment; or
        - (ii) after the entry of a judgment imposing a sentence of death but before the execution of that judgment; shall be entitled to the appointment of one or more attorneys and the furnishing of such other services in accordance with paragraphs (5), (6), (7), (8), and (9).
    - (B) In any post conviction proceeding under section 2254 or 2255 of title 28 seeking to vacate or set aside a death sentence, any defendant who is or becomes financially unable to obtain adequate representation or investigative, expert, or other reasonably necessary services shall be entitled to the appointment of one or more attorneys and the furnishing of such other services in accordance with paragraphs (5), (6), (7), (8), and (9).
- (5) If the appointment is made before judgment, at least one attorney so appointed must have been admitted to practice in the court in which the prosecution is to be tried for not less than five years, and must have had not less than three years experience in the actual trial of felony prosecutions in that court.

- (6) If the appointment is made after judgment, at least one attorney so appointed must have been admitted to practice in the court of appeals for not less than five years, and must have had not less than three years experience in the handling of appeals in that court in felony cases.
- (7) With respect to paragraphs (5) and (6), the court, for good cause, may appoint another attorney whose background, knowledge, or experience would otherwise enable him or her to properly represent the defendant, with due consideration to the seriousness of the possible penalty and to the unique and complex nature of the litigation.
- (8) Unless replaced by similarly qualified counsel upon the attorney's own motion or upon motion of the defendant, each attorney so appointed shall represent the defendant throughout every subsequent stage of available judicial proceedings, including pretrial proceedings, trial, sentencing, motions for new trial, appeals, applications for writ of certiorari to the Supreme Court of the United States, and all available post-conviction process, together with applications for stays of execution and other appropriate motions and procedures, and shall also represent the defendant in such competency proceedings and proceedings for executive or other clemency as may be available to the defendant.
- (9) Upon a finding in ex parte proceedings that investigative, expert or other services are reasonably necessary for the representation of the defendant, whether in connection with issues relating to guilt or sentence, the court shall authorize the defendant's attorneys to obtain such services on behalf of the defendant and shall order the payment of fees and expenses therefore, under paragraph (10). Upon a finding that timely procurement of such services could not practicably await prior authorization, the court may authorize the provision of and payment for such services nunc pro tunc.
- (10) Notwithstanding the rates and maximum limits generally applicable to criminal cases and any other provision of law to the contrary, the court shall fix the compensation to be paid to attorneys appointed under this subsection and the fees and expenses to be paid for investigative, expert, and other reasonably necessary services authorized under paragraph (9), at such rates or amounts as the court determines to be reasonably necessary to carry out the requirements of paragraphs (4) through (9).

- **(r) Refusal to participate by State and Federal correctional employees**

No employee of any State department of corrections or the Federal Bureau of Prisons and no employee providing services to that department or bureau under contract shall be required, as a condition of that employment, or contractual obligation to be in attendance at or to participate in any execution carried out under this section if such participation is contrary to the moral or religious convictions of the employee. For purposes of this subsection, the term "participation in executions" includes personal preparation of the condemned individual and the apparatus used for execution and supervision of the activities of other personnel in carrying out such activities.

§ 849. Transportation safety offenses.

- **(a) Definitions** In this section -

"safety rest area" means a roadside facility with parking facilities for the rest or other needs of motorists.

"truck stop" means a facility (including any parking lot appurtenant thereto) that -

- (A) has the capacity to provide fuel or service, or both, to any commercial motor vehicle (as defined in section 31301 of title 49), operating in commerce (as defined in that section); and
- (B) is located within 2,500 feet of the National System of Interstate and Defense Highways or the Federal-Aid Primary System.

- **(b) First offense**

A person who violates section 841(a)(1) of this title or section 856 of this title by distributing or possessing with intent to distribute a controlled substance in or on, or within 1,000 feet of, a truck stop or safety rest area is (except as provided in subsection (b) (FOOTNOTE 1) of this section) subject to - (FOOTNOTE 1) So in original. Probably should be subsection "(c)".

- (1) twice the maximum punishment authorized by section 841(b) of this title; and
- (2) twice any term of supervised release authorized by section 841(b) of this title for a first offense.

- **(c) Subsequent offense**

A person who violates section 841(a)(1) of this title or section 856 of this title by distributing or possessing with intent to distribute a controlled substance in or on, or within 1,000 feet of, a truck stop or a safety rest area after a prior conviction or convictions under subsection (a) (FOOTNOTE 2) of this section have become final is subject to - (FOOTNOTE 2) So in original. Probably should be subsection "(b)".

- (1) 3 times the maximum punishment authorized by section 841(b) of this title; and
- (2) 3 times any term of supervised release authorized by section 841(b) of this title for a first offense.

§ 850. Information for sentencing.

Except as otherwise provided in this subchapter or section 242a(a) of title 42, no limitation shall be placed on the information concerning the background, character, and conduct of a person convicted of an offense which a court of the United States may

receive and consider for the purpose of imposing an appropriate sentence under this subchapter or subchapter II of this chapter.

§ 851. Proceedings to establish prior convictions.

- **(a) Information filed by United States Attorney**
  - (1) No person who stands convicted of an offense under this part shall be sentenced to increased punishment by reason of one or more prior convictions, unless before trial, or before entry of a plea of guilty, the United States attorney files an information with the court (and serves a copy of such information on the person or counsel for the person) stating in writing the previous convictions to be relied upon. Upon a showing by the United States attorney that facts regarding prior convictions could not with due diligence be obtained prior to trial or before entry of a plea of guilty, the court may postpone the trial or the taking of the plea of guilty for a reasonable period for the purpose of obtaining such facts. Clerical mistakes in the information may be amended at any time prior to the pronouncement of sentence.
  - (2) An information may not be filed under this section if the increased punishment which may be imposed is imprisonment for a term in excess of three years unless the person either waived or was afforded prosecution by indictment for the offense for which such increased punishment may be imposed.

- **(b) Affirmation or denial of previous conviction**

If the United States attorney files an information under this section, the court shall after conviction but before pronouncement of sentence inquire of the person with respect to whom the information was filed whether he affirms or denies that he has been previously convicted as alleged in the information, and shall inform him that any challenge to a prior conviction which is not made before sentence is imposed may not thereafter be raised to attack the sentence.

- **(c) Denial; written response; hearing**
  - (1) If the person denies any allegation of the information of prior conviction, or claims that any conviction alleged is invalid, he shall file a written response to the information. A copy of the response shall be served upon the United States attorney. The court shall hold a hearing to determine any issues raised by the response which would except the person from increased punishment. The failure of the United States attorney to include in the information the complete criminal record of the person or any facts in addition to the convictions to be relied upon shall not constitute grounds for invalidating the notice given in the information required by subsection (a)(1) of this section. The hearing shall be before the court without a jury and either party may introduce evidence. Except as otherwise provided in paragraph (2) of this subsection, the United

States attorney shall have the burden of proof beyond a reasonable doubt on any issue of fact. At the request of either party, the court shall enter findings of fact and conclusions of law.

- (2) A person claiming that a conviction alleged in the information was obtained in violation of the Constitution of the United States shall set forth his claim, and the factual basis therefor, with particularity in his response to the information. The person shall have the burden of proof by a preponderance of the evidence on any issue of fact raised by the response. Any challenge to a prior conviction, not raised by response to the information before an increased sentence is imposed in reliance thereon, shall be waived unless good cause be shown for failure to make a timely challenge.

- **(d) Imposition of sentence**
  - (1) If the person files no response to the information, or if the court determines, after hearing, that the person is subject to increased punishment by reason of prior convictions, the court shall proceed to impose sentence upon him as provided by this part.
  - (2) If the court determines that the person has not been convicted as alleged in the information, that a conviction alleged in the information is invalid, or that the person is otherwise not subject to an increased sentence as a matter of law, the court shall, at the request of the United States attorney, postpone sentence to allow an appeal from that determination. If no such request is made, the court shall impose sentence as provided by this part. The person may appeal from an order postponing sentence as if sentence had been pronounced and a final judgment of conviction entered.

- **(e) Statute of limitations**

No person who stands convicted of an offense under this part may challenge the validity of any prior conviction alleged under this section which occurred more than five years before the date of the information alleging such prior conviction.

§ 852. Application of treaties and other international agreements.

Nothing in the Single Convention on Narcotic Drugs, the Convention on Psychotropic Substances, or other treaties or international agreements shall be construed to limit the provision of treatment, education, or rehabilitation as alternatives to conviction or criminal penalty for offenses involving any drug or other substance subject to control under any such treaty or agreement.

§ 853. Criminal forfeitures.

- **(a) Property subject to criminal forfeiture**

Any person convicted of a violation of this subchapter or subchapter II of this chapter punishable by imprisonment for more than one year shall forfeit to the United States, irrespective of any provision of State law -

- (1) any property constituting, or derived from, any proceeds the person obtained, directly or indirectly, as the result of such violation;
- (2) any of the person's property used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, such violation; and
- (3) in the case of a person convicted of engaging in a continuing criminal enterprise in violation of section 848 of this title, the person shall forfeit, in addition to any property described in paragraph (1) or (2), any of his interest in, claims against, and property or contractual rights affording a source of control over, the continuing criminal enterprise.

The court, in imposing sentence on such person, shall order, in addition to any other sentence imposed pursuant to this subchapter or subchapter II of this chapter, that the person forfeit to the United States all property described in this subsection. In lieu of a fine otherwise authorized by this part, a defendant who derives profits or other proceeds from an offense may be fined not more than twice the gross profits or other proceeds.

- **(b) Meaning of term ''property''**

Property subject to criminal forfeiture under this section includes -

- (1) real property, including things growing on, affixed to, and found in land; and
- (2) tangible and intangible personal property, including rights, privileges, interests, claims, and securities.

- **(c) Third party transfers**

All right, title, and interest in property described in subsection (a) of this section vests in the United States upon the commission of the act giving rise to forfeiture under this section. Any such property that is subsequently transferred to a person other than the defendant may be the subject of a special verdict of forfeiture and thereafter shall be ordered forfeited to the United States, unless the transferee establishes in a hearing pursuant to subsection (n) of this section that he is a bona fide purchaser for value of such property who at the time of purchase was reasonably without cause to believe that the property was subject to forfeiture under this section.

- **(d) Rebuttable presumption**

There is a rebuttable presumption at trial that any property of a person convicted of a felony under this subchapter or subchapter II of this chapter is subject to forfeiture under this section if the United States establishes by a preponderance of the evidence that -

- (1) such property was acquired by such person during the period of the violation of this subchapter or subchapter II of this chapter or within a reasonable time after such period; and
- (2) there was no likely source for such property other than the violation of this subchapter or subchapter II of this chapter.

- **(e) Protective orders**
    - (1) Upon application of the United States, the court may enter a restraining order or injunction, require the execution of a satisfactory performance bond, or take any other action to preserve the availability of property described in subsection (a) of this section for forfeiture under this section -
        - (A) upon the filing of an indictment or information charging a violation of this subchapter or subchapter II of this chapter for which criminal forfeiture may be ordered under this section and alleging that the property with respect to which the order is sought would, in the event of conviction, be subject to forfeiture under this section; or
        - (B) prior to the filing of such an indictment or information, if, after notice to persons appearing to have an interest in the property and opportunity for a hearing, the court determines that -
            - (i) there is a substantial probability that the United States will prevail on the issue of forfeiture and that failure to enter the order will result in the property being destroyed, removed from the jurisdiction of the court, or otherwise made unavailable for forfeiture; and
            - (ii) the need to preserve the availability of the property through the entry of the requested order outweighs the hardship on any party against whom the order is to be entered:

      Provided, however, That an order entered pursuant to subparagraph (B) shall be effective for not more than ninety days, unless extended by the court for good cause shown or unless an indictment or information described in subparagraph (A) has been filed.

    - (2) A temporary restraining order under this subsection may be entered upon application of the United States without notice or opportunity for a hearing when an information or indictment has not yet been filed with respect to the property, if the United States demonstrates that there is probable cause to believe that the property with respect to which the order is sought would, in the event of conviction, be subject to forfeiture under this section and that provision of notice will jeopardize the availability of the property for forfeiture. Such a temporary order shall expire not more than ten days after the date on which it is entered, unless extended for good cause shown or unless the party against whom it is entered consents to an extension for a longer period. A hearing requested concerning an

order entered under this paragraph shall be held at the earliest possible time and prior to the expiration of the temporary order.

- (3) The court may receive and consider, at a hearing held pursuant to this subsection, evidence and information that would be inadmissible under the Federal Rules of Evidence.

- **(f) Warrant of seizure**

The Government may request the issuance of a warrant authorizing the seizure of property subject to forfeiture under this section in the same manner as provided for a search warrant. If the court determines that there is probable cause to believe that the property to be seized would, in the event of conviction, be subject to forfeiture and that an order under subsection (e) of this section may not be sufficient to assure the availability of the property for forfeiture, the court shall issue a warrant authorizing the seizure of such property.

- **(g) Execution**

Upon entry of an order of forfeiture under this section, the court shall authorize the Attorney General to seize all property ordered forfeited upon such terms and conditions as the court shall deem proper. Following entry of an order declaring the property forfeited, the court may, upon application of the United States, enter such appropriate restraining orders or injunctions, require the execution of satisfactory performance bonds, appoint receivers, conservators, appraisers, accountants, or trustees, or take any other action to protect the interest of the United States in the property ordered forfeited. Any income accruing to or derived from property ordered forfeited under this section may be used to offset ordinary and necessary expenses to the property which are required by law, or which are necessary to protect the interests of the United States or third parties.

- **(h) Disposition of property**

Following the seizure of property ordered forfeited under this section, the Attorney General shall direct the disposition of the property by sale or any other commercially feasible means, making due provision for the rights of any innocent persons. Any property right or interest not exercisable by, or transferable for value to, the United States shall expire and shall not revert to the defendant, nor shall the defendant or any person acting in concert with him or on his behalf be eligible to purchase forfeited property at any sale held by the United States. Upon application of a person, other than the defendant or a person acting in concert with him or on his behalf, the court may restrain or stay the sale or disposition of the property pending the conclusion of any appeal of the criminal case giving rise to the forfeiture, if the applicant demonstrates that proceeding with the sale or disposition of the property will result in irreparable injury, harm, or loss to him.

- **(i) Authority of the Attorney General**

With respect to property ordered forfeited under this section, the Attorney General is authorized to -

- (1) grant petitions for mitigation or remission of forfeiture, restore forfeited property to victims of a violation of this subchapter, or take any other action to protect the rights of innocent persons which is in the interest of justice and which is not inconsistent with the provisions of this section;
- (2) compromise claims arising under this section;
- (3) award compensation to persons providing information resulting in a forfeiture under this section;
- (4) direct the disposition by the United States, in accordance with the provisions of section 881(e) of this title, of all property ordered forfeited under this section by public sale or any other commercially feasible means, making due provision for the rights of innocent persons; and
- (5) take appropriate measures necessary to safeguard and maintain property ordered forfeited under this section pending its disposition.

- **(j) Applicability of civil forfeiture provisions**

Except to the extent that they are inconsistent with the provisions of this section, the provisions of section 881(d) of this title shall apply to a criminal forfeiture under this section.

- **(k) Bar on intervention**

Except as provided in subsection (n) of this section, no party claiming an interest in property subject to forfeiture under this section may -

- (1) intervene in a trial or appeal of a criminal case involving the forfeiture of such property under this section; or
- (2) commence an action at law or equity against the United States concerning the validity of his alleged interest in the property subsequent to the filing of an indictment or information alleging that the property is subject to forfeiture under this section.

- **(l) Jurisdiction to enter orders**

The district courts of the United States shall have jurisdiction to enter orders as provided in this section without regard to the location of any property which may be subject to forfeiture under this section or which has been ordered forfeited under this section.

- **(m) Depositions**

In order to facilitate the identification and location of property declared forfeited and to facilitate the disposition of petitions for remission or mitigation of forfeiture, after the entry of an order declaring property forfeited to the United States, the court may, upon

application of the United States, order that the testimony of any witness relating to the property forfeited be taken by deposition and that any designated book, paper, document, record, recording, or other material not privileged be produced at the same time and place, in the same manner as provided for the taking of depositions under Rule 15 of the Federal Rules of Criminal Procedure.

- **(n) Third party interests**
    - (1) Following the entry of an order of forfeiture under this section, the United States shall publish notice of the order and of its intent to dispose of the property in such manner as the Attorney General may direct. The Government may also, to the extent practicable, provide direct written notice to any person known to have alleged an interest in the property that is the subject of the order of forfeiture as a substitute for published notice as to those persons so notified.
    - (2) Any person, other than the defendant, asserting a legal interest in property which has been ordered forfeited to the United States pursuant to this section may, within thirty days of the final publication of notice or his receipt of notice under paragraph (1), whichever is earlier, petition the court for a hearing to adjudicate the validity of his alleged interest in the property. The hearing shall be held before the court alone, without a jury.
    - (3) The petition shall be signed by the petitioner under penalty of perjury and shall set forth the nature and extent of the petitioner's right, title, or interest in the property, the time and circumstances of the petitioner's acquisition of the right, title, or interest in the property, any additional facts supporting the petitioner's claim, and the relief sought.
    - (4) The hearing on the petition shall, to the extent practicable and consistent with the interests of justice, be held within thirty days of the filing of the petition. The court may consolidate the hearing on the petition with a hearing on any other petition filed by a person other than the defendant under this subsection.
    - (5) At the hearing, the petitioner may testify and present evidence and witnesses on his own behalf, and cross-examine witnesses who appear at the hearing. The United States may present evidence and witnesses in rebuttal and in defense of its claim to the property and cross-examine witnesses who appear at the hearing. In addition to testimony and evidence presented at the hearing, the court shall consider the relevant portions of the record of the criminal case which resulted in the order of forfeiture.
    - (6) If, after the hearing, the court determines that the petitioner has established by a preponderance of the evidence that -
        - (A) the petitioner has a legal right, title, or interest in the property, and such right, title, or interest renders the order of forfeiture invalid in whole or in part because the right, title, or interest was vested in the petitioner rather than the defendant or was superior to any right, title, or interest of the defendant at the time of the commission of the acts which gave rise to the forfeiture of the property under this section; or

        - (B) the petitioner is a bona fide purchaser for value of the right, title, or interest in the property and was at the time of purchase reasonably without cause to believe that the property was subject to forfeiture under this section; the court shall amend the order of forfeiture in accordance with its determination.
    - (7) Following the court's disposition of all petitions filed under this subsection, or if no such petitions are filed following the expiration of the period provided in paragraph (2) for the filing of such petitions, the United States shall have clear title to property that is the subject of the order of forfeiture and may warrant good title to any subsequent purchaser or transferee.

- **(o) Construction**

The provisions of this section shall be liberally construed to effectuate its remedial purposes.

- **(p) Forfeiture of substitute property**

If any of the property described in subsection (a) of this section, as a result of any act or omission of the defendant -

- (1) cannot be located upon the exercise of due diligence;
- (2) has been transferred or sold to, or deposited with, a third party;
- (3) has been placed beyond the jurisdiction of the court;
- (4) has been substantially diminished in value; or
- (5) has been commingled with other property which cannot be divided without difficulty;

the court shall order the forfeiture of any other property of the defendant up to the value of any property described in paragraphs (1) through (5).

§ 853a. Transferred.

§ 854. Investment of illicit drug profits.

- **(a) Prohibition**

It shall be unlawful for any person who has received any income derived, directly or indirectly, from a violation of this subchapter or subchapter II of this chapter punishable by imprisonment for more than one year in which such person has participated as a principal within the meaning of section 2 of title 18, to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or

participating in the control of the issuer, or of assisting another to do so, shall not be unlawful under this section if the securities of the issuer held by the purchaser, the members of his immediate family, and his or their accomplices in any violation of this subchapter or subchapter II of this chapter after such purchase do not amount in the aggregate to 1 per centum of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

- **(b) Penalty**

Whoever violates this section shall be fined not more than $50,000 or imprisoned not more than ten years, or both.

- **(c) ''Enterprise'' defined**

As used in this section, the term "enterprise" includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity.

- **(d) Construction**

The provisions of this section shall be liberally construed to effectuate its remedial purposes.

§ 855. Alternative fine.

In lieu of a fine otherwise authorized by this part, a defendant who derives profits or other proceeds from an offense may be fined not more than twice the gross profits or other proceeds.

§ 856. Establishment of manufacturing operations.

- (a) Except as authorized by this subchapter, it shall be unlawful to -
    - (1) knowingly open or maintain any place for the purpose of manufacturing, distributing, or using any controlled substance;
    - (2) manage or control any building, room, or enclosure, either as an owner, lessee, agent, employee, or mortgagee, and knowingly and intentionally rent, lease, or make available for use, with or without compensation, the building, room, or enclosure for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance.

- (b) Any person who violates subsection (a) of this section shall be sentenced to a term of imprisonment of not more than 20 years or a fine of not more than $500,000, or both, or a fine of $2,000,000 for a person other than an individual.

§ 857. Repealed.

Repealed. Pub. L. 101-647, title XXIV, Sec. 2401(d), Nov. 29, 1990, 104 Stat. 4859

§ 858. Endangering human life while illegally manufacturing controlled substance.

Whoever, while manufacturing a controlled substance in violation of this subchapter, or attempting to do so, or transporting or causing to be transported materials, including chemicals, to do so, creates a substantial risk of harm to human life shall be fined in accordance with title 18 or imprisoned not more than 10 years, or both.

§ 859. Distribution to persons under age twenty-one.

- **(a) First offense**

Except as provided in section 860 of this title, any person at least eighteen years of age who violates section 841(a)(1) of this title by distributing a controlled substance to a person under twenty-one years of age is (except as provided in subsection (b) of this section) subject to (1) twice the maximum punishment authorized by section 841(b) of this title, and (2) at least twice any term of supervised release authorized by section 841(b) of this title, for a first offense involving the same controlled substance and schedule. Except to the extent a greater minimum sentence is otherwise provided by section 841(b) of this title, a term of imprisonment under this subsection shall be not less than one year. The mandatory minimum sentencing provisions of this subsection shall not apply to offenses involving 5 grams or less of marihuana.

- **(b) Second offense**

Except as provided in section 860 of this title, any person at least eighteen years of age who violates section 841(a)(1) of this title by distributing a controlled substance to a person under twenty-one years of age after a prior conviction under subsection (a) of this section (or under section 333(b) of this title as in effect prior to May 1, 1971) has become final, is subject to (1) three times the maximum punishment authorized by section 841(b) of this title, and (2) at least three times any term of supervised release authorized by section 841(b) of this title, for a second or subsequent offense involving the same controlled substance and schedule. Except to the extent a greater minimum sentence is otherwise provided by section 841(b) of this title, a term of imprisonment under this subsection shall be not less than one year. Penalties for third and subsequent convictions shall be governed by section 841(b)(1)(A) of this title.

§ 860. Distribution or manufacturing in or near schools and colleges.

- **(a) Penalty**

Any person who violates section 841(a)(1) of this title or section 856 of this title by distributing, possessing with intent to distribute, or manufacturing a controlled substance in or on, or within one thousand feet of, the real property comprising a public or private elementary, vocational, or secondary school or a public or private college, junior college,

or university, or a playground, or housing facility owned by a public housing authority, or within 100 feet of a public or private youth center, public swimming pool, or video arcade facility, is (except as provided in subsection (b) of this section) subject to (1) twice the maximum punishment authorized by section 841(b) of this title; and (2) at least twice any term of supervised release authorized by section 841(b) of this title for a first offense. A fine up to twice that authorized by section 841(b) of this title may be imposed in addition to any term of imprisonment authorized by this subsection. Except to the extent a greater minimum sentence is otherwise provided by section 841(b) of this title, a person shall be sentenced under this subsection to a term of imprisonment of not less than one year. The mandatory minimum sentencing provisions of this paragraph shall not apply to offenses involving 5 grams or less of marihuana.

- **(b) Second offenders**

Any person who violates section 841(a)(1) of this title or section 856 of this title by distributing, possessing with intent to distribute, or manufacturing a controlled substance in or on, or within one thousand feet of, the real property comprising a public or private elementary, vocational, or secondary school or a public or private college, junior college, or university, or a playground, or housing facility owned by a public housing authority, or within 100 feet of a public or private youth center, public swimming pool, or video arcade facility, after a prior conviction under subsection (a) of this section has become final is punishable (1) by the greater of (A) a term of imprisonment of not less than three years and not more than life imprisonment or (B) three times the maximum punishment authorized by section 841(b) of this title for a first offense, and (2) at least three times any term of supervised release authorized by section 841(b) of this title for a first offense. A fine up to three times that authorized by section 841(b) of this title may be imposed in addition to any term of imprisonment authorized by this subsection. Except to the extent a greater minimum sentence is otherwise provided by section 841(b) of this title, a person shall be sentenced under this subsection to a term of imprisonment of not less than three years. Penalties for third and subsequent convictions shall be governed by section 841(b)(1)(A) of this title.

- **(c) Employing children to distribute drugs near schools or playgrounds**

Notwithstanding any other law, any person at least 21 years of age who knowingly and intentionally -

- (1) employs, hires, uses, persuades, induces, entices, or coerces a person under 18 years of age to violate this section; or
- (2) employs, hires, uses, persuades, induces, entices, or coerces a person under 18 years of age to assist in avoiding detection or apprehension for any offense under this section by any Federal, State, or local law enforcement official, is punishable by a term of imprisonment, a fine, or both, up to triple those authorized by section 841 of this title.

- **(d) Suspension of sentence; probation; parole**

In the case of any mandatory minimum sentence imposed under this section, imposition or execution of such sentence shall not be suspended and probation shall not be granted. An individual convicted under this section shall not be eligible for parole until the individual has served the mandatory minimum term of imprisonment as provided by this section.

- **(e) Definitions**

For the purposes of this section -

- (1) The term "playground" means any outdoor facility (including any parking lot appurtenant thereto) intended for recreation, open to the public, and with any portion thereof containing three or more separate apparatus intended for the recreation of children including, but not limited to, sliding boards, swingsets, and teeterboards.
- (2) The term "youth center" means any recreational facility and/or gymnasium (including any parking lot appurtenant thereto), intended primarily for use by persons under 18 years of age, which regularly provides athletic, civic, or cultural activities.
- (3) The term "video arcade facility" means any facility, legally accessible to persons under 18 years of age, intended primarily for the use of pinball and video machines for amusement containing a minimum of ten pinball and/or video machines.
- (4) The term "swimming pool" includes any parking lot appurtenant thereto.

§ 861. Employment or use of persons under 18 years of age in drug operations.

- **(a) Unlawful acts**

It shall be unlawful for any person at least eighteen years of age to knowingly and intentionally -

- (1) employ, hire, use, persuade, induce, entice, or coerce, a person under eighteen years of age to violate any provision of this subchapter or subchapter II of this chapter;
- (2) employ, hire, use, persuade, induce, entice, or coerce, a person under eighteen years of age to assist in avoiding detection or apprehension for any offense of this subchapter or subchapter II of this chapter by any Federal, State, or local law enforcement official; or
- (3) receive a controlled substance from a person under 18 years of age, other than an immediate family member, in violation of this subchapter or subchapter II of this chapter.

- **(b) Penalty for first offense**

Any person who violates subsection (a) of this section is subject to twice the maximum punishment otherwise authorized and at least twice any term of supervised release otherwise authorized for a first offense. Except to the extent a greater minimum sentence is otherwise provided, a term of imprisonment under this subsection shall not be less than one year.

- **(c) Penalty for subsequent offenses**

Any person who violates subsection (a) of this section after a prior conviction under subsection (a) of this section has become final, is subject to three times the maximum punishment otherwise authorized and at least three times any term of supervised release otherwise authorized for a first offense. Except to the extent a greater minimum sentence is otherwise provided, a term of imprisonment under this subsection shall not be less than one year. Penalties for third and subsequent convictions shall be governed by section 841(b)(1)(A) of this title.

- **(d) Penalty for providing or distributing controlled substance to underage person**

Any person who violates subsection (a)(1) or (2) of this section (FOOTNOTE 1) (FOOTNOTE 1) So in original. Probably should be followed by a dash.

- (1) by knowingly providing or distributing a controlled substance or a controlled substance analogue to any person under eighteen years of age; or
- (2) if the person employed, hired, or used is fourteen years of age or younger, shall be subject to a term of imprisonment for not more than five years or a fine of not more than $50,000, or both, in addition to any other punishment authorized by this section.

(e) Suspension of sentence; probation; parole In any case of any sentence imposed under this section, imposition or execution of such sentence shall not be suspended and probation shall not be granted. An individual convicted under this section of an offense for which a mandatory minimum term of imprisonment is applicable shall not be eligible for parole under section 4202 of title 18 (FOOTNOTE 2) until the individual has served the mandatory term of imprisonment as enhanced by this section.

(FOOTNOTE 2) Section 4202 of title 18, referred to in subsec. (e), which, as originally enacted in Title 18, Crimes and Criminal Procedure, related to eligibility of prisoners for parole, was repealed and a new section 4202 enacted as part of the repeal and enactment of a new chapter 311 (Sec. 4201 et seq.) of Title 18, by Pub. L. 94-233, Sec. 2, Mar. 15, 1976, 90 Stat. 219. For provisions relating to the eligibility of prisoners for parole, see section 4205 of Title 18. Pub. L. 98-473, title II, Sec. 218(a)(5), 235(a)(1), (b)(1), Oct. 12, 1984, 98 Stat. 2027, 2031, 2032, as amended, provided that, effective on the first day of the first calendar month beginning 36 months after Oct. 12, 1984 (Nov. 1, 1987), chapter 311 of Title 18 is repealed, subject to remaining effective for five years after Nov. 1, 1987, in certain circumstances.

- **(f) Distribution of controlled substance to pregnant individual**

Except as authorized by this subchapter, it shall be unlawful for any person to knowingly or intentionally provide or distribute any controlled substance to a pregnant individual in violation of any provision of this subchapter. Any person who violates this subsection shall be subject to the provisions of subsections (b), (c), and (e) of this section.

§ 862. Denial of Federal benefits to drug traffickers and possessors.

- **(a) Drug traffickers**
    - (1) Any individual who is convicted of any Federal or State offense consisting of the distribution of controlled substances shall -
        - (A) at the discretion of the court, upon the first conviction for such an offense be ineligible for any or all Federal benefits for up to 5 years after such conviction;
        - (B) at the discretion of the court, upon a second conviction for such an offense be ineligible for any or all Federal benefits for up to 10 years after such conviction; and
        - (C) upon a third or subsequent conviction for such an offense be permanently ineligible for all Federal benefits.
    - (2) The benefits which are denied under this subsection shall not include benefits relating to long-term drug treatment programs for addiction for any person who, if there is a reasonable body of evidence to substantiate such declaration, declares himself to be an addict and submits himself to a long-term treatment program for addiction, or is deemed to be rehabilitated pursuant to rules established by the Secretary of Health and Human Services.

- **(b) Drug possessors**
    - (1) Any individual who is convicted of any Federal or State offense involving the possession of a controlled substance (as such term is defined for purposes of this subchapter) shall -
        - (A) upon the first conviction for such an offense and at the discretion of the court -
            - (i) be ineligible for any or all Federal benefits for up to one year;
            - (ii) be required to successfully complete an approved drug treatment program which includes periodic testing to insure that the individual remains drug free;
            - (iii) be required to perform appropriate community service; or
            - (iv) any combination of clause (i), (ii), or (iii); and
        - (B) upon a second or subsequent conviction for such an offense be ineligible for all Federal benefits for up to 5 years after such conviction as determined by the court. The court shall continue to have the discretion in subparagraph (A) above. In imposing

penalties and conditions under subparagraph (A), the court may require that the completion of the conditions imposed by clause (ii) or (iii) be a requirement for the reinstatement of benefits under clause (i).

- (2) The penalties and conditions which may be imposed under this subsection shall be waived in the case of a person who, if there is a reasonable body of evidence to substantiate such declaration, declares himself to be an addict and submits himself to a long-term treatment program for addiction, or is deemed to be rehabilitated pursuant to rules established by the Secretary of Health and Human Services.

- **(c) Suspension of period of ineligibility**

The period of ineligibility referred to in subsections (a) and (b) of this section shall be suspended if the individual -

- (A) completes a supervised drug rehabilitation program after becoming ineligible under this section;
- (B) has otherwise been rehabilitated; or
- (C) has made a good faith effort to gain admission to a supervised drug rehabilitation program, but is unable to do so because of inaccessibility or unavailability of such a program, or the inability of the individual to pay for such a program.

- **(d) Definitions**

As used in this section -

- (1) the term "Federal benefit" -
  - (A) means the issuance of any grant, contract, loan, professional license, or commercial license provided by an agency of the United States or by appropriated funds of the United States; and
  - (B) does not include any retirement, welfare, Social Security, health, disability, veterans benefit, public housing, or other similar benefit, or any other benefit for which payments or services are required for eligibility; and
- (2) the term "veterans benefit" means all benefits provided to veterans, their families, or survivors by virtue of the service of a veteran in the Armed Forces of the United States.

- **(e) Inapplicability of this section to Government witnesses**

The penalties provided by this section shall not apply to any individual who cooperates or testifies with the Government in the prosecution of a Federal or State offense or who is in a Government witness protection program.

- **(f) Indian provision**

Nothing in this section shall be construed to affect the obligation of the United States to any Indian or Indian tribe arising out of any treaty, statute, Executive order, or the trust responsibility of the United States owing to such Indian or Indian tribe. Nothing in this subsection shall exempt any individual Indian from the sanctions provided for in this section, provided that no individual Indian shall be denied any benefit under Federal Indian programs comparable to those described in subsection (d)(1)(B) or (d)(2) of this section.

- **(g) Presidential report**
  - (1) On or before May 1, 1989, the President shall transmit to the Congress a report -
    - (A) delineating the role of State courts in implementing this section;
    - (B) describing the manner in which Federal agencies will implement and enforce the requirements of this section;
    - (C) detailing the means by which Federal and State agencies, courts, and law enforcement agencies will exchange and share the data and information necessary to implement and enforce the withholding of Federal benefits; and
    - (D) recommending any modifications to improve the administration of this section or otherwise achieve the goal of discouraging the trafficking and possession of controlled substances.
  - (2) No later than September 1, 1989, the Congress shall consider the report of the President and enact such changes as it deems appropriate to further the goals of this section.

- **(h) Effective date**

The denial of Federal benefits set forth in this section shall take effect for convictions occurring after September 1, 1989.

§ 863. Drug paraphernalia.

- **(a) In general**

It is unlawful for any person -

- (1) to sell or offer for sale drug paraphernalia;
- (2) to use the mails or any other facility of interstate commerce to transport drug paraphernalia; or
- (3) to import or export drug paraphernalia.

- **(b) Penalties**

Anyone convicted of an offense under subsection (a) of this section shall be imprisoned for not more than three years and fined under title 18.

- **(c) Seizure and forfeiture**

Any drug paraphernalia involved in any violation of subsection (a) of this section shall be subject to seizure and forfeiture upon the conviction of a person for such violation. Any such paraphernalia shall be delivered to the Administrator of General Services, General Services Administration, who may order such paraphernalia destroyed or may authorize its use for law enforcement or educational purposes by Federal, State, or local authorities.

- **(d) ''Drug paraphernalia'' defined**

The term "drug paraphernalia" means any equipment, product, or material of any kind which is primarily intended or designed for use in manufacturing, compounding, converting, concealing, producing, processing, preparing, injecting, ingesting, inhaling, or otherwise introducing into the human body a controlled substance, possession of which is unlawful under this subchapter. It includes items primarily intended or designed for use in ingesting, inhaling, or otherwise introducing marijuana, (FOOTNOTE 1) cocaine, hashish, hashish oil, PCP, or amphetamines into the human body, such as -
(FOOTNOTE 1) So in original. Probably should be "marihuana,".

- (1) metal, wooden, acrylic, glass, stone, plastic, or ceramic pipes with or without screens, permanent screens, hashish heads, or punctured metal bowls;
- (2) water pipes;
- (3) carburetion tubes and devices;
- (4) smoking and carburetion masks;
- (5) roach clips: meaning objects used to hold burning material, such as a marihuana cigarette, that has become too small or too short to be held in the hand;
- (6) miniature spoons with level capacities of one-tenth cubic centimeter or less;
- (7) chamber pipes;
- (8) carburetor pipes;
- (9) electric pipes;
- (10) air-driven pipes;
- (11) chillums;
- (12) bongs;
- (13) ice pipes or chillers;
- (14) wired cigarette papers; or
- (15) cocaine freebase kits.

- **(e) Matters considered in determination of what constitutes drug paraphernalia**

In determining whether an item constitutes drug paraphernalia, in addition to all other logically relevant factors, the following may be considered:

- (1) instructions, oral or written, provided with the item concerning its use;
- (2) descriptive materials accompanying the item which explain or depict its use;
- (3) national and local advertising concerning its use;
- (4) the manner in which the item is displayed for sale;
- (5) whether the owner, or anyone in control of the item, is a legitimate supplier of like or related items to the community, such as a licensed distributor or dealer of tobacco products;
- (6) direct or circumstantial evidence of the ratio of sales of the item(s) to the total sales of the business enterprise;
- (7) the existence and scope of legitimate uses of the item in the community; and
- (8) expert testimony concerning its use.

- **(f) Exemptions**

This section shall not apply to -

- (1) any person authorized by local, State, or Federal law to manufacture, possess, or distribute such items; or
- (2) any item that, in the normal lawful course of business, is imported, exported, transported, or sold through the mail or by any other means, and traditionally intended for use with tobacco products, including any pipe, paper, or accessory.

PART E - ADMINISTRATIVE AND ENFORCEMENT PROVISIONS

§ 871. Attorney General.

- **(a) Delegation of functions**

The Attorney General may delegate any of his functions under this subchapter to any officer or employee of the Department of Justice.

- **(b) Rules and regulations**

The Attorney General may promulgate and enforce any rules, regulations, and procedures which he may deem necessary and appropriate for the efficient execution of his functions under this subchapter.

- **(c) Acceptance of devices, bequests, gifts, and donations**

The Attorney General may accept in the name of the Department of Justice any form of device, bequest, gift, or donation where the donor intends to donate property for the purpose of preventing or controlling the abuse of controlled substances. He may take all appropriate steps to secure possession of such property and may sell, assign, transfer, or convey any such property other than moneys.

§ 872. Education and research programs of Attorney General.

- **(a) Authorization**

The Attorney General is authorized to carry out educational and research programs directly related to enforcement of the laws under his jurisdiction concerning drugs or other substances which are or may be subject to control under this subchapter. Such programs may include -

- (1) educational and training programs on drug abuse and controlled substances law enforcement for local, State, and Federal personnel;
- (2) studies or special projects designed to compare the deterrent effects of various enforcement strategies on drug use and abuse;
- (3) studies or special projects designed to assess and detect accurately the presence in the human body of drugs or other substances which are or may be subject to control under this subchapter, including the development of rapid field identification methods which would enable agents to detect microquantities of such drugs or other substances;
- (4) studies or special projects designed to evaluate the nature and sources of the supply of illegal drugs throughout the country;
- (5) studies or special projects to develop more effective methods to prevent diversion of controlled substances into illegal channels; and
- (6) studies or special projects to develop information necessary to carry out his functions under section 811 of this title.

- **(b) Contracts**

The Attorney General may enter into contracts for such educational and research activities without performance bonds and without regard to section 5 of title 41.

- **(c) Identification of research populations; authorization to withhold**

The Attorney General may authorize persons engaged in research to withhold the names and other identifying characteristics of persons who are the subjects of such research. Persons who obtain this authorization may not be compelled in any Federal, State, or local civil, criminal, administrative, legislative, or other proceeding to identify the subjects of research for which such authorization was obtained.

- **(d) Affect of treaties and other international agreements on confidentiality**

Nothing in the Single Convention on Narcotic Drugs, the Convention on Psychotropic Substances, or other treaties or international agreements shall be construed to limit, modify, or prevent the protection of the confidentiality of patient records or of the names and other identifying characteristics of research subjects as provided by any Federal, State, or local law or regulation.

- **(e) Use of controlled substances in research**

The Attorney General, on his own motion or at the request of the Secretary, may authorize the possession, distribution, and dispensing of controlled substances by persons engaged in research. Persons who obtain this authorization shall be exempt from State or Federal prosecution for possession, distribution, and dispensing of controlled substances to the extent authorized by the Attorney General.

- **(f) Program to curtail diversion of precursor and essential chemicals**

The Attorney General shall maintain an active program, both domestic and international, to curtail the diversion of precursor chemicals and essential chemicals used in the illicit manufacture of controlled substances.

§ 873. Cooperative arrangements.

- **(a) Cooperation of Attorney General with local, State, and Federal agencies**

The Attorney General shall cooperate with local, State, and Federal agencies concerning traffic in controlled substances and in suppressing the abuse of controlled substances. To this end, he is authorized to -

- (1) arrange for the exchange of information between governmental officials concerning the use and abuse of controlled substances;
- (2) cooperate in the institution and prosecution of cases in the courts of the United States and before the licensing boards and courts of the several States;
- (3) conduct training programs on controlled substance law enforcement for local, State, and Federal personnel;
- (4) maintain in the Department of Justice a unit which will accept, catalog, file, and otherwise utilize all information and statistics, including records of controlled substance abusers and other controlled substance law offenders, which may be received from Federal, State, and local agencies, and make such information available for Federal, State, and local law enforcement purposes;
- (5) conduct programs of eradication aimed at destroying wild or illicit growth of plant species from which controlled substances may be extracted;
- (6) assist State and local governments in suppressing the diversion of controlled substances from legitimate medical, scientific, and commercial channels by -
    - (A) making periodic assessments of the capabilities of State and local governments to adequately control the diversion of controlled substances;

    - (B) providing advice and counsel to State and local governments on the methods by which such governments may strengthen their controls against diversion; and
    - (C) establishing cooperative investigative efforts to control diversion; and
- (7) notwithstanding any other provision of law, enter into contractual agreements with State and local law enforcement agencies to provide for cooperative enforcement and regulatory activities under this chapter. (FOOTNOTE 1)

(FOOTNOTE 1) This chapter, referred to in subsec. (a)(7), was in the original as added by Pub. L. 99-646 "this Act", meaning Pub. L. 91-513, Oct. 27, 1970, 84 Stat. 1236, as amended. In the subsec. (a)(7) added by Pub. L. 99-570, the reference was "this title", meaning title II of Pub. L. 91-513 which is popularly known as the "Controlled Substances Act" and is classified principally to this subchapter. For complete classification of this Act and title II to the Code, see Short Title note set out under section 801 of this title and Tables.

Schedule II, referred to in subsec. (c), is set out in section 812(c) of this title.

- **(b) Requests by Attorney General for assistance from Federal agencies or instrumentalities**

When requested by the Attorney General, it shall be the duty of any agency or instrumentality of the Federal Government to furnish assistance, including technical advice, to him for carrying out his functions under this subchapter; except that no such agency or instrumentality shall be required to furnish the name of, or other identifying information about, a patient or research subject whose identity it has undertaken to keep confidential.

- **(c) Descriptive and analytic reports by Attorney General to State agencies of distribution patterns of schedule II substances having highest rates of abuse**

The Attorney General shall annually (1) select the controlled substances (or controlled substances) contained in schedule II which, in the Attorney General's discretion, is determined to have the highest rate of abuse, and (2) prepare and make available to regulatory, licensing, and law enforcement agencies of States descriptive and analytic reports on the actual distribution patterns in such States of each such controlled substance.

- **(d) Grants by Attorney General**
    - (1) The Attorney General may make grants, in accordance with paragraph (2), to State and local governments to assist in meeting the costs of -
        - (A) collecting and analyzing data on the diversion of controlled substances,
        - (B) conducting investigations and prosecutions of such diversions,
        - (C) improving regulatory controls and other authorities to control such diversions,

        - (D) programs to prevent such diversions,
        - (E) preventing and detecting forged prescriptions, and
        - (F) training law enforcement and regulatory personnel to improve the control of such diversions.
    - (2) No grant may be made under paragraph (1) unless an application therefor is submitted to the Attorney General in such form and manner as the Attorney General may prescribe. No grant may exceed 80 per centum of the costs for which the grant is made, and no grant may be made unless the recipient of the grant provides assurances satisfactory to the Attorney General that it will obligate funds to meet the remaining 20 per centum of such costs. The Attorney General shall review the activities carried out with grants under paragraph (1) and shall report annually to Congress on such activities.
    - (3) To carry out this subsection there is authorized to be appropriated $6,000,000 for fiscal year 1985 and $6,000,000 for fiscal year 1986.

§ 874. Advisory committees.

The Attorney General may from time to time appoint committees to advise him with respect to preventing and controlling the abuse of controlled substances. Members of the committees may be entitled to receive compensation at the rate of $100 for each day (including traveltime) during which they are engaged in the actual performance of duties. While traveling on official business in the performance of duties for the committees, members of the committees shall be allowed expenses of travel, including per diem instead of subsistence, in accordance with subchapter I of chapter 57 of title 5.

§ 875. Administrative hearings.

- **(a) Power of Attorney General**

In carrying out his functions under this subchapter, the Attorney General may hold hearings, sign and issue subpenas, administer oaths, examine witnesses, and receive evidence at any place in the United States.

- **(b) Procedures applicable**

Except as otherwise provided in this subchapter, notice shall be given and hearings shall be conducted under appropriate procedures of subchapter II of chapter 5 of title 5.

§ 876. Subpenas.

- **(a) Authorization of use by Attorney General**

In any investigation relating to his functions under this subchapter with respect to controlled substances, listed chemicals, tableting machines, or encapsulating machines, the Attorney General may subpena witnesses, compel the attendance and testimony of

witnesses, and require the production of any records (including books, papers, documents, and other tangible things which constitute or contain evidence) which the Attorney General finds relevant or material to the investigation. The attendance of witnesses and the production of records may be required from any place in any State or in any territory or other place subject to the jurisdiction of the United States at any designated place of hearing; except that a witness shall not be required to appear at any hearing more than 500 miles distant from the place where he was served with a subpena. Witnesses summoned under this section shall be paid the same fees and mileage that are paid witnesses in the courts of the United States.

- **(b) Service**

A subpena issued under this section may be served by any person designated in the subpena to serve it. Service upon a natural person may be made by personal delivery of the subpena to him. Service may be made upon a domestic or foreign corporation or upon a partnership or other unincorporated association which is subject to suit under a common name, by delivering the subpena to an officer, to a managing or general agent, or to any other agent authorized by appointment or by law to receive service of process. The affidavit of the person serving the subpena entered a true copy thereof by the person serving it shall be proof of service.

- **(c) Enforcement**

In the case of contumacy by or refusal to obey a subpena issued to any person, the Attorney General may invoke the aid of any court of the United States within the jurisdiction of which the investigation is carried on or of which the subpenaed person is an inhabitant, or in which he carries on business or may be found, to compel compliance with the subpena. The court may issue an order requiring the subpenaed person to appear before the Attorney General to produce records, if so ordered, or to give testimony touching the matter under investigation. Any failure to obey the order of the court may be punished by the court as a contempt thereof. All process in any such case may be served in any judicial district in which such person may be found.

§ 877. Judicial review.

All final determinations, findings, and conclusions of the Attorney General under this subchapter shall be final and conclusive decisions of the matters involved, except that any person aggrieved by a final decision of the Attorney General may obtain review of the decision in the United States Court of Appeals for the District of Columbia or for the circuit in which his principal place of business is located upon petition filed with the court and delivered to the Attorney General within thirty days after notice of the decision. Findings of fact by the Attorney General, if supported by substantial evidence, shall be conclusive.

§ 878. Powers of enforcement personnel.

- (a) Any officer or employee of the Drug Enforcement Administration or any State or local law enforcement officer designated by the Attorney General may -
    - (1) carry firearms;
    - (2) execute and serve search warrants, arrest warrants, administrative inspection warrants, subpenas, and summonses issued under the authority of the United States;
    - (3) make arrests without warrant (A) for any offense against the United States committed in his presence, or (B) for any felony, cognizable under the laws of the United States, if he has probable cause to believe that the person to be arrested has committed or is committing a felony;
    - (4) make seizures of property pursuant to the provisions of this subchapter; and
    - (5) perform such other law enforcement duties as the Attorney General may designate.

- (b) State and local law enforcement officers performing functions under this section shall not be deemed Federal employees and shall not be subject to provisions of law relating to Federal employees, except that such officers shall be subject to section 3374(c) of title 5.

§ 879. Search warrants.

A search warrant relating to offenses involving controlled substances may be served at any time of the day or night if the judge or United States magistrate judge issuing the warrant is satisfied that there is probable cause to believe that grounds exist for the warrant and for its service at such time.

§ 880. Administrative inspections and warrants.

- **(a) ''Controlled premises'' defined**

As used in this section, the term "controlled premises" means -

- (1) places where original or other records or documents required under this subchapter are kept or required to be kept, and
- (2) places, including factories, warehouses, and other establishments, and conveyances, where persons registered under section 823 of this title (or exempt from registration under section 822(d) of this title or by regulation of the Attorney General) or regulated persons may lawfully hold, manufacture, distribute, dispense, administer, or otherwise dispose of controlled substances or listed chemicals or where records relating to those activities are maintained.

- **(b) Grant of authority; scope of inspections**
    - (1) For the purpose of inspecting, copying, and verifying the correctness of records, reports, or other documents required to be kept or made under this subchapter and otherwise facilitating the carrying out of his functions

under this subchapter, the Attorney General is authorized, in accordance with this section, to enter controlled premises and to conduct administrative inspections thereof, and of the things specified in this section, relevant to those functions.

- (2) Such entries and inspections shall be carried out through officers or employees (hereinafter referred to as "inspectors") designated by the Attorney General. Any such inspector, upon stating his purpose and presenting to the owner, operator, or agent in charge of such premises (A) appropriate credentials and (B) a written notice of his inspection authority (which notice in the case of an inspection requiring, or in fact supported by, an administrative inspection warrant shall consist of such warrant), shall have the right to enter such premises and conduct such inspection at reasonable times.
- (3) Except as may otherwise be indicated in an applicable inspection warrant, the inspector shall have the right -
  - (A) to inspect and copy records, reports, and other documents required to be kept or made under this subchapter;
  - (B) to inspect, within reasonable limits and in a reasonable manner, controlled premises and all pertinent equipment, finished and unfinished drugs, listed chemicals, and other substances or materials, containers, and labeling found therein, and, except as provided in paragraph (4) of this subsection, all other things therein (including records, files, papers, processes, controls, and facilities) appropriate for verification of the records, reports, and documents referred to in clause (A) or otherwise bearing on the provisions of this subchapter; and
  - (C) to inventory any stock of any controlled substance or listed chemical therein and obtain samples of any such substance or chemical.
- (4) Except when the owner, operator, or agent in charge of the controlled premises so consents in writing, no inspection authorized by this section shall extend to -
  - (A) financial data;
  - (B) sales data other than shipment data; or
  - (C) pricing data.

- **(c) Situations not requiring warrants**

A warrant under this section shall not be required for the inspection of books and records pursuant to an administrative subpena issued in accordance with section 876 of this title, nor for entries and administrative inspections (including seizures of property) -

- (1) with the consent of the owner, operator, or agent in charge of the controlled premises;
- (2) in situations presenting imminent danger to health or safety;

- (3) in situations involving inspection of conveyances where there is reasonable cause to believe that the mobility of the conveyance makes it impracticable to obtain a warrant;
- (4) in any other exceptional or emergency circumstance where time or opportunity to apply for a warrant is lacking; or
- (5) in any other situations where a warrant is not constitutionally required.

- **(d) Administrative inspection warrants; issuance; execution; probable cause**

Issuance and execution of administrative inspection warrants shall be as follows:

- (1) Any judge of the United States or of a State court of record, or any United States magistrate judge, may, within his territorial jurisdiction, and upon proper oath or affirmation showing probable cause, issue warrants for the purpose of conducting administrative inspections authorized by this subchapter or regulations thereunder, and seizures of property appropriate to such inspections. For the purposes of this section, the term "probable cause" means a valid public interest in the effective enforcement of this subchapter or regulations thereunder sufficient to justify administrative inspections of the area, premises, building, or conveyance, or contents thereof, in the circumstances specified in the application for the warrant.
- (2) A warrant shall issue only upon an affidavit of an officer or employee having knowledge of the facts alleged, sworn to before the judge or magistrate judge and establishing the grounds for issuing the warrant. If the judge or magistrate judge is satisfied that grounds for the application exist or that there is probable cause to believe they exist, he shall issue a warrant identifying the area, premises, building, or conveyance to be inspected, the purpose of such inspection, and, where appropriate, the type of property to be inspected, if any. The warrant shall identify the items or types of property to be seized, if any. The warrant shall be directed to a person authorized under subsection (b)(2) of this section to execute it. The warrant shall state the grounds for its issuance and the name of the person or persons whose affidavit has been taken in support thereof. It shall command the person to whom it is directed to inspect the area, premises, building, or conveyance identified for the purpose specified, and, where appropriate, shall direct the seizure of the property specified. The warrant shall direct that it be served during normal business hours. It shall designate the judge or magistrate judge to whom it shall be returned.
- (3) A warrant issued pursuant to this section must be executed and returned within ten days of its date unless, upon a showing by the United States of a need therefor, the judge or magistrate judge allows additional time in the warrant. If property is seized pursuant to a warrant, the person executing the warrant shall give to the person from whom or from whose premises the property was taken a copy of the warrant and a receipt for the property taken or shall leave the copy and receipt at the place from which the property was taken. The return of the warrant shall be made promptly and shall be accompanied by a written inventory of any property taken. The inventory shall be made in the presence of the person executing the

warrant and of the person from whose possession or premises the property was taken, if they are present, or in the presence of at least one credible person other than the person making such inventory, and shall be verified by the person executing the warrant. The judge or magistrate judge, upon request, shall deliver a copy of the inventory to the person from whom or from whose premises the property was taken and the applicant for the warrant.

- (4) The judge or magistrate judge who has issued a warrant under this section shall attach to the warrant a copy of the return and all papers filed in connection therewith and shall file them with the clerk of the district court of the United States for the judicial district in which the inspection was made.

§ 881. Forfeitures.

- **(a) Subject property**

The following shall be subject to forfeiture to the United States and no property right shall exist in them:

- (1) All controlled substances which have been manufactured, distributed, dispensed, or acquired in violation of this subchapter.
- (2) All raw materials, products, and equipment of any kind which are used, or intended for use, in manufacturing, compounding, processing, delivering, importing, or exporting any controlled substance in violation of this subchapter.
- (3) All property which is used, or intended for use, as a container for property described in paragraph (1), (2), or (9).
- (4) All conveyances, including aircraft, vehicles, or vessels, which are used, or are intended for use, to transport, or in any manner to facilitate the transportation, sale, receipt, possession, or concealment of property described in paragraph (1), (2), or (9), except that -
    - (A) no conveyance used by any person as a common carrier in the transaction of business as a common carrier shall be forfeited under the provisions of this section unless it shall appear that the owner or other person in charge of such conveyance was a consenting party or privy to a violation of this subchapter or subchapter II of this chapter;
    - (B) no conveyance shall be forfeited under the provisions of this section by reason of any act or omission established by the owner thereof to have been committed or omitted by any person other than such owner while such conveyance was unlawfully in the possession of a person other than the owner in violation of the criminal laws of the United States, or of any State; and
    - (C) no conveyance shall be forfeited under this paragraph to the extent of an interest of an owner, by reason of any act or omission established by that owner to have been committed or omitted without the knowledge, consent, or willful blindness of the owner.
- (5) All books, records, and research, including formulas, microfilm, tapes, and data which are used, or intended for use, in violation of this subchapter.

- (6) All moneys, negotiable instruments, securities, or other things of value furnished or intended to be furnished by any person in exchange for a controlled substance in violation of this subchapter, all proceeds traceable to such an exchange, and all moneys, negotiable instruments, and securities used or intended to be used to facilitate any violation of this subchapter, except that no property shall be forfeited under this paragraph, to the extent of the interest of an owner, by reason of any act or omission established by that owner to have been committed or omitted without the knowledge or consent of that owner.
- (7) All real property, including any right, title, and interest (including any leasehold interest) in the whole of any lot or tract of land and any appurtenances or improvements, which is used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, a violation of this subchapter punishable by more than one year's imprisonment, except that no property shall be forfeited under this paragraph, to the extent of an interest of an owner, by reason of any act or omission established by that owner to have been committed or omitted without the knowledge or consent of that owner.
- (8) All controlled substances which have been possessed in violation of this subchapter.
- (9) All listed chemicals, all drug manufacturing equipment, all tableting machines, all encapsulating machines, and all gelatin capsules, which have been imported, exported, manufactured, possessed, distributed, or intended to be distributed, imported, or exported, in violation of a felony provision of this subchapter or subchapter II of this chapter.
- (10) Any drug paraphernalia (as defined in section 1822 of the Mail Order Drug Paraphernalia Control Act). (FOOTNOTE 1)

  (FOOTNOTE 1) Section 1822 of the Mail Order Drug Paraphernalia Control Act, referred to in subsec. (a)(10), is section 1822 of Pub. L. 99-570, title I, Oct. 27, 1986, 100 Stat. 3207-51, which was repealed by Pub. L. 101-647, title XXIV, Sec. 2401(d), Nov. 29, 1990, 104 Stat. 4859. Prior to repeal, subsec. (d) of section 1822 of Pub. L. 99-570, which defined "drug paraphernalia", was transferred to subsec. (d) of section 422 of title II of Pub. L. 91-513, the Controlled Substances Act. Section 422 of Pub. L. 91-513 is classified to section 863 of this title.

- (11) Any firearm (as defined in section 921 of title 18) used or intended to be used to facilitate the transportation, sale, receipt, possession, or concealment of property described in paragraph (1) or (2) and any proceeds traceable to such property.

- **(b) Seizure pursuant to Supplemental Rules for Certain Admiralty and Maritime Claims; issuance of warrant authorizing seizure**

Any property subject to civil forfeiture to the United States under this subchapter may be seized by the Attorney General upon process issued pursuant to the Supplemental Rules for Certain Admiralty and Maritime Claims by any district court of the United States

having jurisdiction over the property, except that seizure without such process may be made when -

- (1) the seizure is incident to an arrest or a search under a search warrant or an inspection under an administrative inspection warrant;
- (2) the property subject to seizure has been the subject of a prior judgment in favor of the United States in a criminal injunction or forfeiture proceeding under this subchapter;
- (3) the Attorney General has probable cause to believe that the property is directly or indirectly dangerous to health or safety; or
- (4) the Attorney General has probable cause to believe that the property is subject to civil forfeiture under this subchapter.

In the event of seizure pursuant to paragraph (3) or (4) of this subsection, proceedings under subsection (d) of this section shall be instituted promptly. The Government may request the issuance of a warrant authorizing the seizure of property subject to forfeiture under this section in the same manner as provided for a search warrant under the Federal Rules of Criminal Procedure.

- **(c) Custody of Attorney General**

Property taken or detained under this section shall not be repleviable, but shall be deemed to be in the custody of the Attorney General, subject only to the orders and decrees of the court or the official having jurisdiction thereof. Whenever property is seized under any of the provisions of this subchapter, the Attorney General may -

- (1) place the property under seal;
- (2) remove the property to a place designated by him; or
- (3) require that the General Services Administration take custody of the property and remove it, if practicable, to an appropriate location for disposition in accordance with law.

- **(d) Other laws and proceedings applicable**

The provisions of law relating to the seizure, summary and judicial forfeiture, and condemnation of property for violation of the customs laws; the disposition of such property or the proceeds from the sale thereof; the remission or mitigation of such forfeitures; and the compromise of claims shall apply to seizures and forfeitures incurred, or alleged to have been incurred, under any of the provisions of this subchapter, insofar as applicable and not inconsistent with the provisions hereof; except that such duties as are imposed upon the customs officer or any other person with respect to the seizure and forfeiture of property under the customs laws shall be performed with respect to seizures and forfeitures of property under this subchapter by such officers, agents, or other persons as may be authorized or designated for that purpose by the Attorney General, except to the extent that such duties arise from seizures and forfeitures effected by any customs officer.

- **(e) Disposition of forfeited property**
  - (1) Whenever property is civilly or criminally forfeited under this subchapter the Attorney General may -
    - (A) retain the property for official use or, in the manner provided with respect to transfers under section 1616a of title 19, transfer the property to any Federal agency or to any State or local law enforcement agency which participated directly in the seizure or forfeiture of the property;
    - (B) except as provided in paragraph (4), sell, by public sale or any other commercially feasible means, any forfeited property which is not required to be destroyed by law and which is not harmful to the public;
    - (C) require that the General Services Administration take custody of the property and dispose of it in accordance with law;
    - (D) forward it to the Bureau of Narcotics and Dangerous Drugs for disposition (including delivery for medical or scientific use to any Federal or State agency under regulations of the Attorney General); or
    - (E) transfer the forfeited personal property or the proceeds of the sale of any forfeited personal or real property to any foreign country which participated directly or indirectly in the seizure or forfeiture of the property, if such a transfer -
      - (i) has been agreed to by the Secretary of State;
      - (ii) is authorized in an international agreement between the United States and the foreign country; and
      - (iii) is made to a country which, if applicable, has been certified under section 2291j(b) of title 22.
  - (2)
    - (A) The proceeds from any sale under subparagraph (B) of paragraph (1) and any moneys forfeited under this subchapter shall be used to pay -
      - (i) all property expenses of the proceedings for forfeiture and sale including expenses of seizure, maintenance of custody, advertising, and court costs; and
      - (ii) awards of up to $100,000 to any individual who provides original information which leads to the arrest and conviction of a person who kills or kidnaps a Federal drug law enforcement agent. Any award paid for information concerning the killing or kidnapping of a Federal drug law enforcement agent, as provided in clause (ii), shall be paid at the discretion of the Attorney General.
    - (B) The Attorney General shall forward to the Treasurer of the United States for deposit in accordance with section 524(c) of title 28, any amounts of such moneys and proceeds remaining after payment of the expenses provided in subparagraph (A), except that, with respect to forfeitures conducted by the Postal Service,

the Postal Service shall deposit in the Postal Service Fund, under section 2003(b)(7) of title 39, such moneys and proceeds.

- (3) The Attorney General shall assure that any property transferred to a State or local law enforcement agency under paragraph (1)(A) -
  - (A) has a value that bears a reasonable relationship to the degree of direct participation of the State or local agency in the law enforcement effort resulting in the forfeiture, taking into account the total value of all property forfeited and the total law enforcement effort with respect to the violation of law on which the forfeiture is based; and
  - (B) will serve to encourage further cooperation between the recipient State or local agency and Federal law enforcement agencies.
- (4)
  - (A) With respect to real property described in subparagraph (B), if the chief executive officer of the State involved submits to the Attorney General a request for purposes of such subparagraph, the authority established in such subparagraph is in lieu of the authority established in paragraph (1)(B).
  - (B) In the case of property described in paragraph (1)(B) that is civilly or criminally forfeited under this subchapter, if the property is real property that is appropriate for use as a public area reserved for recreational or historic purposes or for the preservation of natural conditions, the Attorney General, upon the request of the chief executive officer of the State in which the property is located, may transfer title to the property to the State, either without charge or for a nominal charge, through a legal instrument providing that -
    - (i) such use will be the principal use of the property; and
    - (ii) title to the property reverts to the United States in the event that the property is used otherwise.

- **(f) Forfeiture and destruction of schedule I and II substances**
  - (1) All controlled substances in schedule I or II that are possessed, transferred, sold, or offered for sale in violation of the provisions of this subchapter; all dangerous, toxic, or hazardous raw materials or products subject to forfeiture under subsection (a)(2) of this section; and any equipment or container subject to forfeiture under subsection (a)(2) or (3) of this section which cannot be separated safely from such raw materials or products shall be deemed contraband and seized and summarily forfeited to the United States. Similarly, all substances in schedule I or II, which are seized or come into the possession of the United States, the owners of which are unknown, shall be deemed contraband and summarily forfeited to the United States.
  - (2) The Attorney General may direct the destruction of all controlled substances in schedule I or II seized for violation of this subchapter; all dangerous, toxic, or hazardous raw materials or products subject to

forfeiture under subsection (a)(2) of this section; and any equipment or container subject to forfeiture under subsection (a)(2) or (3) of this section which cannot be separated safely from such raw materials or products under such circumstances as the Attorney General may deem necessary.

- **(g) Plants**
  - (1) All species of plants from which controlled substances in schedules I and II may be derived which have been planted or cultivated in violation of this subchapter, or of which the owners or cultivators are unknown, or which are wild growths, may be seized and summarily forfeited to the United States.
  - (2) The failure, upon demand by the Attorney General or his duly authorized agent, of the person in occupancy or in control of land or premises upon which such species of plants are growing or being stored, to produce an appropriate registration, or proof that he is the holder thereof, shall constitute authority for the seizure and forfeiture.
  - (3) The Attorney General, or his duly authorized agent, shall have authority to enter upon any lands, or into any dwelling pursuant to a search warrant, to cut, harvest, carry off, or destroy such plants.

- **(h) Vesting of title in United States**

All right, title, and interest in property described in subsection (a) of this section shall vest in the United States upon commission of the act giving rise to forfeiture under this section.

- **(i) Stay of civil forfeiture proceedings**

The filing of an indictment or information alleging a violation of this subchapter or subchapter II of this chapter, or a violation of State or local law that could have been charged under this subchapter or subchapter II of this chapter, which is also related to a civil forfeiture proceeding under this section shall, upon motion of the United States and for good cause shown, stay the civil forfeiture proceeding.

- **(j) Venue**

In addition to the venue provided for in section 1395 of title 28 or any other provision of law, in the case of property of a defendant charged with a violation that is the basis for forfeiture of the property under this section, a proceeding for forfeiture under this section may be brought in the judicial district in which the defendant owning such property is found or in the judicial district in which the criminal prosecution is brought. (l) (FOOTNOTE 2) Agreement between Attorney General and Postal Service for performance of functions (FOOTNOTE 2) So in original. No subsec. (k) has been enacted. The functions of the Attorney General under this section shall be carried out by the Postal Service pursuant to such agreement as may be entered into between the Attorney General and the Postal Service.

§ 881-1, 881a. Transferred.

§ 882. Injunctions.

- **(a) Jurisdiction**

The district courts of the United States and all courts exercising general jurisdiction in the territories and possessions of the United States shall have jurisdiction in proceedings in accordance with the Federal Rules of Civil Procedure to enjoin violations of this subchapter.

- **(b) Jury trial**

In case of an alleged violation of an injunction or restraining order issued under this section, trial shall, upon demand of the accused, be by a jury in accordance with the Federal Rules of Civil Procedure.

§ 883. Enforcement proceedings.

Before any violation of this subchapter is reported by the Administrator of the Drug Enforcement Administration to any United States attorney for institution of a criminal proceeding, the Administrator may require that the person against whom such proceeding is contemplated is given appropriate notice and an opportunity to present his views, either orally or in writing, with regard to such contemplated proceeding.

§ 884. Immunity and privilege.

- **(a) Refusal to testify**

Whenever a witness refuses, on the basis of his privilege against self-incrimination, to testify or provide other information in a proceeding before a court or grand jury of the United States, involving a violation of this subchapter, and the person presiding over the proceeding communicates to the witness an order issued under this section, the witness may not refuse to comply with the order on the basis of his privilege against self-incrimination. But no testimony or other information compelled under the order issued under subsection (b) of this section or any information obtained by the exploitation of such testimony or other information, may be used against the witness in any criminal case, including any criminal case brought in a court of a State, except a prosecution for perjury, giving a false statement, or otherwise failing to comply with the order.

- **(b) Order of United States district court**

In the case of any individual who has been or may be called to testify or provide other information at any proceeding before a court or grand jury of the United States, the United States district court for the judicial district in which the proceeding is or may be held shall issue, upon the request of the United States attorney for such district, an order

requiring such individual to give any testimony or provide any other information which he refuses to give or provide on the basis of his privilege against self-incrimination.

- **(c) Request by United States attorney**

A United States attorney may, with the approval of the Attorney General or the Deputy Attorney General, the Associate Attorney General, or any Assistant Attorney General designated by the Attorney General, request an order under subsection (b) of this section when in his judgment -

- (1) the testimony or other information from such individual may be necessary to the public interest; and
- (2) such individual has refused or is likely to refuse to testify or provide other information on the basis of his privilege against self-incrimination.

§ 885. Burden of proof; liabilities.

- **(a) Exemptions and exceptions; presumption in simple possession offenses**
  - (1) It shall not be necessary for the United States to negative any exemption or exception set forth in this subchapter in any complaint, information, indictment, or other pleading or in any trial, hearing, or other proceeding under this subchapter, and the burden of going forward with the evidence with respect to any such exemption or exception shall be upon the person claiming its benefit.
  - (2) In the case of a person charged under section 844(a) of this title with the possession of a controlled substance, any label identifying such substance for purposes of section 353(b)(2) of this title shall be admissible in evidence and shall be prima facie evidence that such substance was obtained pursuant to a valid prescription from a practitioner while acting in the course of his professional practice.

- **(b) Registration and order forms**

In the absence of proof that a person is the duly authorized holder of an appropriate registration or order form issued under this subchapter, he shall be presumed not to be the holder of such registration or form, and the burden of going forward with the evidence with respect to such registration or form shall be upon him.

- **(c) Use of vehicles, vessels, and aircraft**

The burden of going forward with the evidence to establish that a vehicle, vessel, or aircraft used in connection with controlled substances in schedule I was used in accordance with the provisions of this subchapter shall be on the persons engaged in such use.

- **(d) Immunity of Federal, State, local and other officials**

Except as provided in section 2234 and 2235 of title 18, no civil or criminal liability shall be imposed by virtue of this subchapter upon any duly authorized Federal officer lawfully engaged in the enforcement of this subchapter, or upon any duly authorized officer of any State, territory, political subdivision thereof, the District of Columbia, or any possession of the United States, who shall be lawfully engaged in the enforcement of any law or municipal ordinance relating to controlled substances.

§ 886. Payments and advances.

- **(a) Payment to informers**

The Attorney General is authorized to pay any person, from funds appropriated for the Drug Enforcement Administration, for information concerning a violation of this subchapter, such sum or sums of money as he may deem appropriate, without reference to any moieties or rewards to which such person may otherwise be entitled by law.

- **(b) Reimbursement for purchase of controlled substances**

Moneys expended from appropriations of the Drug Enforcement Administration for purchase of controlled substances and subsequently recovered shall be reimbursed to the current appropriation for the Administration. (FOOTNOTE 1)

(FOOTNOTE 1) In subsec. (b), "Administration" substituted for "Bureau" as the probable intent of Congress in view of amendment by Pub. L. 96-132, which substituted references to the Drug Enforcement Administration for references to the Bureau of Narcotics and Dangerous Drugs wherever appearing in text.

- **(c) Advance of funds for enforcement purposes**

The Attorney General is authorized to direct the advance of funds by the Treasury Department in connection with the enforcement of this subchapter.

- **(d) Drug Pollution Fund**
  - (1) There is established in the Treasury a trust fund to be known as the "Drug Pollution Fund" (hereinafter referred to in this subsection as the "Fund"), consisting of amounts appropriated or credited to such Fund under section 841(b)(6) of this title.
  - (2) There are hereby appropriated to the Fund amounts equivalent to the fines imposed under section 841(b)(6) of this title.
  - (3) Amounts in the Fund shall be available, as provided in appropriations Acts, for the purpose of making payments in accordance with paragraph (4) for the clean up of certain pollution resulting from the actions referred to in section 841(b)(6) of this title.
  - (4)
    - (A) The Secretary of the Treasury, after consultation with the Attorney General, shall make payments under paragraph (3), in

such amounts as the Secretary determines appropriate, to the heads of executive agencies or departments that meet the requirements of subparagraph (B).

- (B) In order to receive a payment under paragraph (3), the head of an executive agency or department shall submit an application in such form and containing such information as the Secretary of the Treasury shall by regulation require. Such application shall contain a description of the fine imposed under section 841(b)(6) of this title, the circumstances surrounding the imposition of such fine, and the type and severity of pollution that resulted from the actions to which such fine applies.

- (5) For purposes of subchapter B of chapter 98 of title 26, the Fund established under this paragraph shall be treated in the same manner as a trust fund established under subchapter A of such chapter.

§ 886a. Diversion Control Fee Account.

There is established in the general fund of the Treasury a separate account which shall be known as the Diversion Control Fee Account. For fiscal year 1993 and thereafter:

- (1) There shall be deposited as offsetting receipts into that account all fees collected by the Drug Enforcement Administration, in excess of $15,000,000, for the operation of its diversion control program.
- (2) Such amounts as are deposited into the Diversion Control Fee Account shall remain available until expended and shall be refunded out of that account by the Secretary of the Treasury, at least on a quarterly basis, to reimburse the Drug Enforcement Administration for expenses incurred in the operation of the diversion control program.
- (3) Fees charged by the Drug Enforcement Administration under its diversion control program shall be set at a level that ensures the recovery of the full costs of operating the various aspects of that program.
- (4) The amount required to be refunded from the Diversion Control Fee Account for fiscal year 1994 and thereafter shall be refunded in accordance with estimates made in the budget request of the Attorney General for those fiscal years. Any proposed changes in the amounts designated in said budget requests shall only be made after notification to the Committees on Appropriations of the House of Representatives and the Senate fifteen days in advance.
- (5) The Attorney General shall prepare and submit annually to the Congress, statements of financial condition of the account, including the beginning balance, receipts, refunds to appropriations, transfers to the general fund, and the ending balance.

§ 887. Coordination and consolidation of post-seizure administration.

The Attorney General and the Secretary of the Treasury shall take such action as may be necessary to develop and maintain a joint plan to coordinate and consolidate post-seizure

administration of property seized under this subchapter, subchapter II of this chapter, or provisions of the customs laws relating to controlled substances.

§ 888. Expedited procedures for seized conveyances.

- **(a) Petition for expedited decision; determination**
  - (1) The owner of a conveyance may petition the Attorney General for an expedited decision with respect to the conveyance, if the conveyance is seized for a drug-related offense and the owner has filed the requisite claim and cost bond in the manner provided in section 1608 of title 19. The Attorney General shall make a determination on a petition under this section expeditiously, including a determination of any rights or defenses available to the petitioner. If the Attorney General does not grant or deny a petition under this section within 20 days after the date on which the petition is filed, the conveyance shall be returned to the owner pending further forfeiture proceedings.
  - (2) With respect to a petition under this section, the Attorney General may -
    - (A) deny the petition and retain possession of the conveyance;
    - (B) grant the petition, move to dismiss the forfeiture action, if filed, and promptly release the conveyance to the owner; or
    - (C) advise the petitioner that there is not adequate information available to determine the petition and promptly release the conveyance to the owner.
  - (3) Release of a conveyance under subsection (a)(1) or (a)(2)(C) of this section does not affect any forfeiture action with respect to the conveyance.
  - (4) The Attorney General shall prescribe regulations to carry out this section.

- **(b) Written notice of procedures**

At the time of seizure, the officer making the seizure shall furnish to any person in possession of the conveyance a written notice specifying the procedures under this section. At the earliest practicable opportunity after determining ownership of the seized conveyance, the head of the department or agency that seizes the conveyance shall furnish a written notice to the owner and other interested parties (including lienholders) of the legal and factual basis of the seizure.

- **(c) Complaint for forfeiture**

Not later than 60 days after a claim and cost bond have been filed under section 1608 of title 19 regarding a conveyance seized for a drug-related offense, the Attorney General shall file a complaint for forfeiture in the appropriate district court, except that the court may extend the period for filing for good cause shown or on agreement of the parties. If the Attorney General does not file a complaint as specified in the preceding sentence, the

court shall order the return of the conveyance to the owner and the forfeiture may not take place.

- **(d) Bond for release of conveyance**

Any owner of a conveyance seized for a drug-related offense may obtain release of the conveyance by providing security in the form of a bond to the Attorney General in an amount equal to the value of the conveyance unless the Attorney General determines the conveyance should be retained (1) as contraband, (2) as evidence of a violation of law, or (3) because, by reason of design or other characteristic, the conveyance is particularly suited for use in illegal activities.

§ 889. Production control of controlled substances.

- **(a) Definitions**

As used in this section:

- (1) The term "controlled substance" has the same meaning given such term in section 802(6) of this title.
- (2) The term "Secretary" means the Secretary of Agriculture.
- (3) The term "State" means each of the fifty States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Virgin Islands of the United States, American Samoa, the Commonwealth of the Northern Mariana Islands, or the Trust Territory of the Pacific Islands.

- **(b) Persons ineligible for Federal agricultural program benefits**

Notwithstanding any other provision of law, following December 23, 1985, any person who is convicted under Federal or State law of planting, cultivation, growing, producing, harvesting, or storing a controlled substance in any crop year shall be ineligible for -

- (1) as to any commodity produced during that crop year, and the four succeeding crop years, by such person -
    - (A) any price support or payment made available under the Agricultural Act of 1949 (7 U.S.C. 1421 et seq.), the Commodity Credit Corporation Charter Act (15 U.S.C. 714 et seq.), or any other Act;
    - (B) a farm storage facility loan made under section 4(h) of the Commodity Credit Corporation Charter Act (15 U.S.C. 714b(h));
    - (C) crop insurance under the Federal Crop Insurance Act (7 U.S.C. 1501 et seq.);
    - (D) a disaster payment made under the Agricultural Act of 1949 (7 U.S.C. 1421 et seq.); or
    - (E) a loan made, insured or guaranteed under the Consolidated Farm and Rural Development Act (7 U.S.C. 1921 et seq.) or any other provision of law administered by the Farmers Home Administration; or

- (2) a payment made under section 4 or 5 of the Commodity Credit Corporation Charter Act (15 U.S.C. 714b or 714c) for the storage of an agricultural commodity that is -
    - (A) produced during that crop year, or any of the four succeeding crop years, by such person; and
    - (B) acquired by the Commodity Credit Corporation.

- **(c) Regulations**

Not later than 180 days after December 23, 1985, the Secretary shall issue such regulations as the Secretary determines are necessary to carry out this section, including regulations that -

- (1) define the term "person";
- (2) govern the determination of persons who shall be ineligible for program benefits under this section; and
- (3) protect the interests of tenants and sharecroppers.

PART F Advisory Commission

- **(a)** There is established a commission to be known as the Commission on Marihuana and Drug Abuse (hereafter in this section referred to as the 'Commission'). The Commission shall be composed of -
    - (1) two Members of the Senate appointed by the President of the Senate;
    - (2) two Members of the House of Representatives appointed by the Speaker of the House of Representatives; and
    - (3) nine members appointed by the President of the United States. At no time shall more than one of the members appointed under paragraph (1), or more than one of the members appointed under paragraph (2), or more than five of the members appointed under paragraph (3) be members of the same political party.

- **(b) (Chairman; Vice Chairman; compensation of members; meetings)**
    - (1) The President shall designate one of the members of the Commission as Chairman and one as Vice Chairman. Seven members of the Commission shall constitute a quorum, but a lesser number may conduct hearings.
    - (2) Members of the Commission who are Members of Congress or full-time officers or employees of the United States shall serve without additional compensation but shall be reimbursed for travel, subsistence,

and other necessary expenses incurred in the performance of the duties vested in the Commission. Members of the Commission from private life shall receive $100 per diem while engaged in the actual performance of the duties vested in the Commission, plus reimbursement for travel, subsistence, and other necessary expenses incurred in the performance of such duties.

- (3) The Commission shall meet at the call of the Chairman or at the call of a majority of the members thereof.

- **(c) (Personnel; experts; information from departments and agencies**)
  - (1) The Commission shall have the power to appoint and fix the compensation of such personnel as it deems advisable, without regard to the provisions of title 5, United States Code, governing appointments in the competitive service, and the provisions of chapter 51 and subchapter III of chapter 53 of such title, relating to classification and General Schedule pay rates.
  - (2) The Commission may procure, in accordance with the provisions of section 3109 of title 5, United States Code, the temporary or intermittent services of experts or consultants. Persons so employed shall receive compensation at a rate to be fixed by the Commission, but not in excess of $75 per diem, including traveltime. While away from his home or regular place of business in the performance of services for the Commission, any such person may be allowed travel expenses, including per diem in lieu of subsistence, as authorized by section 5703(b) of title 5, United States Code, for persons in the Government service employed intermittently.
  - (3) The Commission may secure directly from any department or agency of the United States information necessary to enable it to carry out its duties under this section. Upon request of the Chairman of the Commission, such department or agency shall furnish such information to the Commission.

- **(d) (Marihuana study; report to the President and the Congress)**
  - (1) The Commission shall conduct a study of marihuana including, but not limited to, the following areas:
    - (A) the extent of use of marihuana in the United States to include its various sources of users, number of arrests, number of convictions, amount of marihuana seized, type of user, nature of use;
    - (B) an evaluation of the efficacy of existing marihuana laws;
    - (C) a study of the pharmacology of marihuana and its immediate and long-term effects, both physiological and psychological;
    - (D) the relationship of marihuana use to aggressive behavior and crime;
    - (E) the relationship between marihuana and the use of other drugs; and
    - (F) the international control of marihuana.

- (2) Within one year after the date on which funds first become available to carry out this section, the Commission shall submit to the President and the Congress a comprehensive report on its study and investigation under this subsection which shall include its recommendations and such proposals for legislation and administrative action as may be necessary to carry out its recommendations.

- **(e) (Study and investigation of causes of drug abuse; report to the President and the Congress; termination of Commission)**

The Commission shall conduct a comprehensive study and investigation of the causes of drug abuse and their relative significance. The Commission shall submit to the President and the Congress such interim reports as it deems advisable and shall within two years after the date on which funds first become available to carry out this section submit to the President and the Congress a final report which shall contain a detailed statement of its findings and conclusions and also such recommendations for legislation and administrative actions as it deems appropriate. The Commission shall cease to exist sixty days after the final report is submitted under this subsection.

- **(f) (Limitation on expenditures)**

Total expenditures of the Commission shall not exceed $4,000,000."

Part G - Conforming, Transitional and Effective Date, and General Provisions

§ 701 Repeals and Conforming Amendments

(a) Sections 201(v), 301(q), and 511 of the Federal Food, Drug and Cosmetic Act (21 USC 321(v), 331(q), 360(a)) are repealed.

(b) Subsections (a) and (b) of section 303 of the Federal Food, Drug and Cosmetic Act (21 USC 333) are amended to read as follows:

- Federal Food, Drug and Cosmetic Act (21 USC 333)
  - (a) Violation of section 331 of this title; second violation; intent to defraud or mislead
    - (1) Any person who violates a provision of section 331 of this title shall be imprisoned for not more than one year or fined not more than $1,000, or both.
    - (2) Notwithstanding the provisions of paragraph (1) of this section, (FOOTNOTE 1) if any person commits such a violation after a conviction of him under this section has become final, or commits

such a violation with the intent to defraud or mislead, such person shall be imprisoned for not more than three years or fined not more than $10,000, or both.

(FOOTNOTE 1) So in original. Words "of this section" probably should not appear.

(c) Section 304(a)(2) of the Federal Food, Drug and Cosmetic Act (21 USC 334) amended in 1970 - Subsec. (a)(2). Pub. L. 91-513, Sec. 701(c), struck out cls. (A) and (D) which dealt with depressant or stimulant drugs, struck out reference to depressant or stimulant drugs in cl. (C), and redesignated cls. (B), (C), and (E) as cls. (A), (B), and (C), respectively.

(d) Section 304(d)(3)(iii). of the Federal Food, Drug and Cosmetic Act (21 USC 334(d)(3)(iii)) Pub. L. 91-513, Sec. 701(d), struck out reference to depressant or stimulant drugs.

(e) Section 510 of the Federal Food, Drug and Cosmetic Act (21 USC 360) is amended (1) in Subsec. (a) by striking out paragraph (2), and by inserting "and" at the end of paragraph (1), and by redesignating paragraph (3) as paragraph (2); (2) Subsec. (b). Pub. L. 91-513 struck out provisions covering establishments engaged in the wholesaling, jobbing, or distributing of depressant or stimulant drugs and the inclusion of the fact of such activity in the annual registration; (3) by striking out the last sentence of subsection (b); (4) Subsec. (c). Pub. L. 91-513 struck out provisions covering new registrations of persons first engaging in the wholesaling, jobbing, or distributing of depressant or stimulant drugs and the inclusion of the fact of such activity in the registration; (5) by striking out the last sentence of subsection (c); (6) by striking out "1)" in subsection (d) and by inserting a period after "drug or drugs" in that subsection and deleting the remainder of that subsection; and (7) by striking out "and certain wholesalers" in the section heading.

(f) Sec 702 of the Federal Food, Drug and Cosmetic Act (21 USC 372) is amended 1970 - Subsec. (e). Pub. L. 91-513 struck out reference to depressant or stimulant drugs.

(g) Section 201(a)(2) of the Federal Food, Drug and Cosmetic Act (21 USC 321(a)(2)) is amended by inserting a period after "Canal Zone" the first time these words appear and deleting all thereafter in such section 201(a)(2).

(h) The last sentence of Section 801(a) of the Federal Food, Drug and Cosmetic Act (21 USC 381(a) is amended (1) by striking out "This paragraph" and inserting in lieu thereof "Clause (2) of the third sentence of this paragraph," and (2) by striking out "section 2 of the Act of May 26, 1922, as amended (USC 1934, edition, title 21, sec 173)" and inserting in lieu thereof "the Controlled Substances Import and Export Act."

(i)

- (1) Section 1114 of title 18, United States Code, is amended by striking out "the Bureau of Narcotics" and inserting in lieu thereof "the Bureau of Narcotics and Dangerous Drugs".
- (2) Section 1952 of such title is amended-
    - (A) by inserting in subsection (b)(1) "or controlled substances (as defined in section 102(6) of the Controlled Substances Act)" immediately following "narcotics"; and
    - (B) by striking out "or narcotics" in subsection (c).

(j) Subsection (a) of section 302 of the Public Health Service Act (42 USC 242(a)) is amended to read as follows:

- (a) In carrying out the purposes of section 241 of this title with respect to drugs the use or misuse of which might result in drug abuse or dependency, the studies and investigations authorized therein shall include the use and misuse of narcotic drugs and other drugs. Such studies and investigations shall further include the quantities of crude opium, coca leaves, and their salts, derivatives, and preparations, and other drugs subject to control under the Controlled Substances Act (21 U.S.C. 801 et seq.) and Controlled Substances Import and Export Act (21 U.S.C. 951 et seq.), together with reserves thereof, necessary to supply the normal and emergency medicinal and scientific requirements of the United States. The results of studies and investigations of the quantities of narcotic drugs or other drugs subject to control under such Acts, together with reserves of such drugs, that are necessary to supply the normal and emergency medicinal and scientific requirements of the United States, shall be reported not later than the first day of April of each year to the Attorney General, to be used at his discretion in determining manufacturing quotas or importation requirements under such Acts.

§ 702 [321 note] Pending Proceedings

(a) Prosecutions for any violation of law occurring prior to the effective date (see Effective Date of 1970 Amendment note above) of section 701 (repealing section 360a of this title, and amending sections 321, 331, 333, 334, 360, 372, and 381 of this title, sections 1114 and 1952 of Title 18, Crimes and Criminal Procedure, and section 242 of Title 42, The Public Health and Welfare) shall not be affected by the repeals or amendments made by such section, or abated by reason thereof.

(b) Civil seizures or forfeitures and injunctive proceedings commenced prior to the effective date of section 701 shall not be affected by the repeals or amendments made by such section, or abated by reason thereof.

(c) All administrative proceedings pending before the Bureau of Narcotics and Dangerous Drugs (now the Drug Enforcement Administration) on the date of enactment of this Act (Oct. 27, 1970) shall be continued and brought to final determination in accord with laws and regulations in effect prior to such date of enactment. Where a drug is finally determined under such proceedings to be a depressant or stimulant drug, as

defined in section 201(v) of the Federal Food, Drug, and Cosmetic Act (par. (v) of this section), such drug shall automatically be controlled under this title (subchapter I of chapter 13 of this title) by the Attorney General without further proceedings and listed in the appropriate schedule after he has obtained the recommendation of the Secretary. Any drug with respect to which such a final determination has been made prior to the date of enactment of this Act which is not listed in section 202 (section 812 of this title) within schedules I through V shall automatically be controlled under this title (subchapter I of chapter 13 of this title) by the Attorney General without further proceedings, and be listed in the appropriate schedule, after he has obtained the recommendations of the Secretary.

(d) Notwithstanding subsection (a) of this section or section 1103 (of Pub. L. 91-513, set out as a note under sections 171 to 174 of this title), section 4202 of title 18, United States Code, shall apply to any individual convicted under any of the laws repealed by this title or title III (subchapter I or subchapter II of chapter 13 of this title) without regard to the terms of any sentence imposed on such individual under such law.

§ 703 [822 note] Provisional Proceedings

- (a)
    - (1) Any person who -
        - (A) is engaged in manufacturing, distributing, or dispensing any controlled substance on the day before the effective date of section 302 (this section), and
        - (B) is registered on such day under section 510 of the Federal Food, Drug, and Cosmetic Act (section 360 of this title) or under section 4722 of the Internal Revenue Code of 1986 (formerly I.R.C. 1954, section 4722 of Title 26),

      shall, with respect to each establishment for which such registration is in effect under any such section, be deemed to have a provisional registration under section 303 (section 823 of this title) for the manufacture, distribution, or dispensing (as the case may be) of controlled substances.

    - (2) During the period his provisional registration is in effect under this section, the registration number assigned such person under such section 510 (section 360 of this title) or under such section 4722 (section 4722 of Title 26) (as the case may be) shall be his registration number for purposes of section 303 of this title (section 823 of this title).

- (b) The provisions of section 304 (section 824 of this title), relating to suspension and revocation of registration, shall apply to a provisional registration under this section.

- (c) Unless sooner suspended or revoked under subsection (b), a provisional registration of a person under subsection (a)(1) of this section shall be in effect until -

- (1) the date on which such person has registered with the Attorney General under section 303 (section 823 of this title) or has had his registration denied under such section, or
- (2) such date as may be prescribed by the Attorney General for registration of manufacturers, distributors, or dispensers, as the case may be, whichever occurs first.

§ 704 [801 note] Effective Dates and Other Transitional Provisions.

(a) Except as otherwise provided in this section, this title (see Short Title note below) shall become effective on the first day of the seventh calendar month that begins after the day immediately preceding the date of enactment (Oct. 27, 1970).

(b) Parts A, B, E, and F of this title (Parts A, B, E, and F of this subchapter), section 702 (set out as a note under section 321 of this title), this section, and sections 705 through 709 (sections 901 to 904 of this title and note set out below), shall become effective upon enactment (Oct. 27, 1970).

(c) Sections 305 (relating to labels and labeling) (section 825 of this title), and 306 (relating to manufacturing quotas) (section 826 of this title) shall become effective on the date specified in subsection (a) of this section, except that the Attorney General may by order published in the Federal Register postpone the effective date of either or both of these sections for such period as he may determine to be necessary for the efficient administration of this title (see Short Title note below).

§ 705 [801 note] Continuation of Regulations.

Any orders, rules, and regulations which have been promulgated under any law affected by this title (see Short Title note above) and which are in effect on the day preceding enactment of this title (Oct. 27, 1970) shall continue in effect until modified, superseded, or repealed.

§ 706 [901] Severability

If a provision of this chapter is held invalid, all valid provisions that are severable shall remain in effect. If a provision of this chapter is held invalid in one or more of its applications, the provision shall remain in effect in all its valid applications that are severable.

§ 707 [902] Savings Provision

Nothing in this chapter, except this part and, to the extent of any inconsistency, sections 827(e) and 829 of this title, shall be construed as in any way affecting, modifying, repealing, or superseding the provisions of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. Sec. 301 et seq.).

§ 708 [903] Application of State Law

No provision of this subchapter shall be construed as indicating an intent on the part of the Congress to occupy the field in which that provision operates, including criminal penalties, to the exclusion of any State law on the same subject matter which would otherwise be within the authority of the State, unless there is a positive conflict between that provision of this subchapter and that State law so that the two cannot consistently stand together.

§ 709 [904] Payment of Tort Claims

Notwithstanding section 2680(k) of title 28, the Attorney General, in carrying out the functions of the Department of Justice under this subchapter, is authorized to pay tort claims in the manner authorized by section 2672 of title 28, when such claims arise in a foreign country in connection with the operations of the Drug Enforcement Administration abroad.

SUPREME COURT OF THE UNITED STATES

No. 03–1454

ALBERTO R. GONZALES, ATTORNEY GENERAL, ET AL., PETITIONERS *v.* ANGEL MCCLARY RAICH ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[June 6, 2005]

JUSTICE STEVENS delivered the opinion of the Court.

California is one of at least nine States that authorize the use of marijuana for medicinal purposes.[1] The question presented in this case is whether the power vested in Congress by Article I, §8, of the Constitution "[t]o make all Laws which shall be necessary and proper for carrying into Execution" its authority to "regulate Commerce with foreign Nations, and among the several States" includes the power to prohibit the local cultivation and use of marijuana in compliance with California law.

[1]See Alaska Stat. §§11.71.090, 17.37.010–17.37.080 (Lexis 2004); Colo. Const., Art. XVIII, §14, Colo. Rev. Stat. §18–18–406.3 (Lexis 2004); Haw. Rev. Stat. §§329–121 to 329–128 (2004 Cum. Supp.); Me. Rev. Stat. Ann., Tit. 22, §2383–B(5) (West 2004); Nev. Const., Art. 4, §38, Nev. Rev. Stat. §§453A.010–453A.810 (2003); Ore. Rev. Stat. §§475.300–475.346 (2003); Vt. Stat. Ann., Tit. 18, §§4472–4474d (Supp. 2004); Wash. Rev. Code §§69.51.010–69.51.080 (2004); see also Ariz. Rev. Stat. Ann. §13–3412.01 (West Supp. 2004) (voter initiative permitting physicians to prescribe Schedule I substances for medical purposes that was purportedly repealed in 1997, but the repeal was rejected by voters in 1998). In November 2004, Montana voters approved Initiative 148, adding to the number of States authorizing the use of marijuana for medical purposes.

I

California has been a pioneer in the regulation of marijuana. In 1913, California was one of the first States to prohibit the sale and possession of marijuana,[2] and at the end of the century, California became the first State to authorize limited use of the drug for medicinal purposes. In 1996, California voters passed Proposition 215, now codified as the Compassionate Use Act of 1996.[3] The proposition was designed to ensure that "seriously ill" residents of the State have access to marijuana for medical purposes, and to encourage Federal and State Governments to take steps towards ensuring the safe and affordable distribution of the drug to patients in need.[4] The Act creates an exemption from criminal prosecution for physicians,[5] as well as for

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[2] 1913 Cal. Stats. ch. 324, §8*a;* see also Gieringer, The Origins of Cannabis Prohibition in California, Contemporary Drug Problems, 21–23 (rev. 2005).

[3] Cal. Health & Safety Code Ann. §11362.5 (West Supp. 2005). The California Legislature recently enacted additional legislation supplementing the Compassionate Use Act. §§11362.7–11362.9 (West Supp. 2005).

[4] "The people of the State of California hereby find and declare that the purposes of the Compassionate Use Act of 1996 are as follows:

"(A) To ensure that seriously ill Californians have the right to obtain and use marijuana for medical purposes where that medical use is deemed appropriate and has been recommended by a physician who has determined that the person's health would benefit from the use of marijuana in the treatment of cancer, anorexia, AIDS, chronic pain, spasticity, glaucoma, arthritis, migraine, or any other illness for which marijuana provides relief.

"(B) To ensure that patients and their primary caregivers who obtain and use marijuana for medical purposes upon the recommendation of a physician are not subject to criminal prosecution or sanction.

"(C) To encourage the federal and state governments to implement a plan to provide for the safe and affordable distribution of marijuana to all patients in medical need of marijuana." §11362.5(b)(1) (West Supp. 2005).

[5] "Notwithstanding any other provision of law, no physician in this state shall be punished, or denied any right or privilege, for having

patients and primary caregivers who possess or cultivate marijuana for medicinal purposes with the recommendation or approval of a physician.[6] A "primary caregiver" is a person who has consistently assumed responsibility for the housing, health, or safety of the patient.[7]

Respondents Angel Raich and Diane Monson are California residents who suffer from a variety of serious medical conditions and have sought to avail themselves of medical marijuana pursuant to the terms of the Compassionate Use Act. They are being treated by licensed, board-certified family practitioners, who have concluded, after prescribing a host of conventional medicines to treat respondents' conditions and to alleviate their associated symptoms, that marijuana is the only drug available that provides effective treatment. Both women have been using marijuana as a medication for several years pursuant to their doctors' recommendation, and both rely heavily on cannabis to function on a daily basis. Indeed, Raich's physician believes that forgoing cannabis treatments would certainly cause Raich excruciating pain and could very well prove fatal.

Respondent Monson cultivates her own marijuana, and ingests the drug in a variety of ways including smoking and using a vaporizer. Respondent Raich, by contrast, is unable to cultivate her own, and thus relies on two caregivers, litigating as "John Does," to provide her with locally grown marijuana at no charge. These caregivers also

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recommended marijuana to a patient for medical purposes." §11362.5(c) (West Supp. 2005).

[6] "Section 11357, relating to the possession of marijuana, and Section 11358, relating to the cultivation of marijuana, shall not apply to a patient, or to a patient's primary caregiver, who possesses or cultivates marijuana for the personal medical purposes of the patient upon the written or oral recommendation or approval of a physician." §11362.5(d) (West Supp. 2005).

[7] §11362.5(e) (West Supp. 2005).

process the cannabis into hashish or keif, and Raich herself processes some of the marijuana into oils, balms, and foods for consumption.

On August 15, 2002, county deputy sheriffs and agents from the federal Drug Enforcement Administration (DEA) came to Monson's home. After a thorough investigation, the county officials concluded that her use of marijuana was entirely lawful as a matter of California law. Nevertheless, after a 3-hour standoff, the federal agents seized and destroyed all six of her cannabis plants.

Respondents thereafter brought this action against the Attorney General of the United States and the head of the DEA seeking injunctive and declaratory relief prohibiting the enforcement of the federal Controlled Substances Act (CSA), 84 Stat. 1242, 21 U. S. C. §801 *et seq*., to the extent it prevents them from possessing, obtaining, or manufacturing cannabis for their personal medical use. In their complaint and supporting affidavits, Raich and Monson described the severity of their afflictions, their repeatedly futile attempts to obtain relief with conventional medications, and the opinions of their doctors concerning their need to use marijuana. Respondents claimed that enforcing the CSA against them would violate the Commerce Clause, the Due Process Clause of the Fifth Amendment, the Ninth and Tenth Amendments of the Constitution, and the doctrine of medical necessity.

The District Court denied respondents' motion for a preliminary injunction. *Raich* v. *Ashcroft,* 248 F. Supp. 2d 918 (ND Cal. 2003). Although the court found that the federal enforcement interests "wane[d]" when compared to the harm that California residents would suffer if denied access to medically necessary marijuana, it concluded that respondents could not demonstrate a likelihood of success on the merits of their legal claims. *Id.*, at 931.

A divided panel of the Court of Appeals for the Ninth Circuit reversed and ordered the District Court to enter a

preliminary injunction.[8] *Raich* v. *Ashcroft*, 352 F. 3d 1222 (2003). The court found that respondents had "demonstrated a strong likelihood of success on their claim that, as applied to them, the CSA is an unconstitutional exercise of Congress' Commerce Clause authority." *Id.,* at 1227. The Court of Appeals distinguished prior Circuit cases upholding the CSA in the face of Commerce Clause challenges by focusing on what it deemed to be the "*separate and distinct class of activities*" at issue in this case: "the intrastate, noncommercial cultivation and possession of cannabis for personal medical purposes as recommended by a patient's physician pursuant to valid California state law." *Id.*, at 1228. The court found the latter class of activities "different in kind from drug trafficking" because interposing a physician's recommendation raises different health and safety concerns, and because "this limited use is clearly distinct from the broader illicit drug market—as well as any broader commercial market for medicinal marijuana—insofar as the medicinal marijuana at issue in this case is not intended for, nor does it enter, the stream of commerce." *Ibid.*

The majority placed heavy reliance on our decisions in *United States* v. *Lopez,* 514 U. S. 549 (1995), and *United States* v. *Morrison,* 529 U. S. 598 (2000), as interpreted by recent Circuit precedent, to hold that this separate class of purely local activities was beyond the reach of federal power. In contrast, the dissenting judge concluded that

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[8] On remand, the District Court entered a preliminary injunction enjoining petitioners "'from arresting or prosecuting Plaintiffs Angel McClary Raich and Diane Monson, seizing their medical cannabis, forfeiting their property, or seeking civil or administrative sanctions against them with respect to the intrastate, non-commercial cultivation, possession, use, and obtaining without charge of cannabis for personal medical purposes on the advice of a physician and in accordance with state law, and which is not used for distribution, sale, or exchange.'" Brief for Petitioners 9.

the CSA, as applied to respondents, was clearly valid under *Lopez* and *Morrison;* moreover, he thought it "simply impossible to distinguish the relevant conduct surrounding the cultivation and use of the marijuana crop at issue in this case from the cultivation and use of the wheat crop that affected interstate commerce in *Wickard* v. *Filburn*." 352 F. 3d, at 1235 (Beam, J., dissenting) (citation omitted).

The obvious importance of the case prompted our grant of certiorari. 542 U. S. 936 (2004). The case is made difficult by respondents' strong arguments that they will suffer irreparable harm because, despite a congressional finding to the contrary, marijuana does have valid therapeutic purposes. The question before us, however, is not whether it is wise to enforce the statute in these circumstances; rather, it is whether Congress' power to regulate interstate markets for medicinal substances encompasses the portions of those markets that are supplied with drugs produced and consumed locally. Well-settled law controls our answer. The CSA is a valid exercise of federal power, even as applied to the troubling facts of this case. We accordingly vacate the judgment of the Court of Appeals.

II

Shortly after taking office in 1969, President Nixon declared a national "war on drugs."[9] As the first campaign of that war, Congress set out to enact legislation that would consolidate various drug laws on the books into a comprehensive statute, provide meaningful regulation over legitimate sources of drugs to prevent diversion into illegal channels, and strengthen law enforcement tools against the traffic in illicit drugs.[10] That effort culminated

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[9] See D. Musto & P. Korsmeyer, The Quest for Drug Control 60 (2002) (hereinafter Musto & Korsmeyer).

[10] H. R. Rep. No. 91–1444, pt. 2, p. 22 (1970) (hereinafter H. R. Rep.); 26 Congressional Quarterly Almanac 531 (1970) (hereinafter Almanac);

in the passage of the Comprehensive Drug Abuse Prevention and Control Act of 1970, 84 Stat. 1236.

This was not, however, Congress' first attempt to regulate the national market in drugs. Rather, as early as 1906 Congress enacted federal legislation imposing labeling regulations on medications and prohibiting the manufacture or shipment of any adulterated or misbranded drug traveling in interstate commerce.[11] Aside from these labeling restrictions, most domestic drug regulations prior to 1970 generally came in the guise of revenue laws, with the Department of the Treasury serving as the Federal Government's primary enforcer.[12] For example, the primary drug control law, before being repealed by the passage of the CSA, was the Harrison Narcotics Act of 1914, 38 Stat. 785 (repealed 1970). The Harrison Act sought to exert control over the possession and sale of narcotics, specifically cocaine and opiates, by requiring producers, distributors, and purchasers to register with the Federal Government, by assessing taxes against parties so registered, and by regulating the issuance of prescriptions.[13]

Marijuana itself was not significantly regulated by the Federal Government until 1937 when accounts of marijuana's addictive qualities and physiological effects, paired with dissatisfaction with enforcement efforts at state and local levels, prompted Congress to pass the Marihuana Tax Act, Pub. L. 75–238, 50 Stat. 551 (repealed 1970).[14]

Musto & Korsmeyer 56–57.

[11] Pure Food and Drug Act of 1906, ch. 3915, 34 Stat. 768, repealed by Act of June 25, 1938, ch. 675, §902(a), 52 Stat. 1059.

[12] See *United States* v. *Doremus,* 249 U. S. 86 (1919); *Leary* v. *United States,* 395 U. S. 6, 14–16 (1969).

[13] See *Doremus*, 249 U. S., at 90–93.

[14] R. Bonnie & C. Whitebread, The Marijuana Conviction 154–174 (1999); L. Grinspoon & J. Bakalar, Marihuana, the Forbidden Medicine 7–8 (rev. ed. 1997) (hereinafter Grinspoon & Bakalar). Although this was the Federal Government's first attempt to regulate the marijuana trade, by this time all States had in place some form of legislation

Like the Harrison Act, the Marihuana Tax Act did not outlaw the possession or sale of marijuana outright. Rather, it imposed registration and reporting requirements for all individuals importing, producing, selling, or dealing in marijuana, and required the payment of annual taxes in addition to transfer taxes whenever the drug changed hands.[15] Moreover, doctors wishing to prescribe marijuana for medical purposes were required to comply with rather burdensome administrative requirements.[16] Noncompliance exposed traffickers to severe federal penalties, whereas compliance would often subject them to prosecution under state law.[17] Thus, while the Marihuana Tax Act did not declare the drug illegal *per se*, the onerous administrative requirements, the prohibitively expensive taxes, and the risks attendant on compliance practically curtailed the marijuana trade.

Then in 1970, after declaration of the national "war on drugs," federal drug policy underwent a significant transformation. A number of noteworthy events precipitated this policy shift. First, in *Leary* v. *United States,* 395 U. S. 6 (1969), this Court held certain provisions of the Marihuana Tax Act and other narcotics legislation unconstitutional. Second, at the end of his term, President Johnson fundamentally reorganized the federal drug control agencies. The Bureau of Narcotics, then housed in the Department of Treasury, merged with the Bureau of Drug Abuse Control, then housed in the Department of Health, Education, and Welfare (HEW), to create the Bureau of Narcotics and Dangerous Drugs, currently housed in the Department of Justice.[18] Finally, prompted by a perceived

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regulating the sale, use, or possession of marijuana. R. Isralowitz, Drug Use, Policy, and Management 134 (2d ed. 2002).

[15] *Leary*, 395 U. S., at 14–16.

[16] Grinspoon & Bakalar 8.

[17] *Leary*, 395 U. S., at 16–18.

[18] Musto & Korsmeyer 32–35; 26 Almanac 533. In 1973, the Bureau

need to consolidate the growing number of piecemeal drug laws and to enhance federal drug enforcement powers, Congress enacted the Comprehensive Drug Abuse Prevention and Control Act.[19]

Title II of that Act, the CSA, repealed most of the earlier antidrug laws in favor of a comprehensive regime to combat the international and interstate traffic in illicit drugs. The main objectives of the CSA were to conquer drug abuse and to control the legitimate and illegitimate traffic in controlled substances.[20] Congress was particularly

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of Narcotics and Dangerous Drugs became the Drug Enforcement Administration (DEA). See Reorg. Plan No. 2 of 1973, §1, 28 CFR §0.100 (1973).

[19] The Comprehensive Drug Abuse Prevention and Control Act of 1970 consists of three titles. Title I relates to the prevention and treatment of narcotic addicts through HEW (now the Department of Health and Human Services). 84 Stat. 1238. Title II, as discussed in more detail above, addresses drug control and enforcement as administered by the Attorney General and the DEA. *Id.,* at 1242. Title III concerns the import and export of controlled substances. *Id.,* at 1285.

[20] In particular, Congress made the following findings:

"(1) Many of the drugs included within this subchapter have a useful and legitimate medical purpose and are necessary to maintain the health and general welfare of the American people.

"(2) The illegal importation, manufacture, distribution, and possession and improper use of controlled substances have a substantial and detrimental effect on the health and general welfare of the American people.

"(3) A major portion of the traffic in controlled substances flows through interstate and foreign commerce. Incidents of the traffic which are not an integral part of the interstate or foreign flow, such as manufacture, local distribution, and possession, nonetheless have a substantial and direct effect upon interstate commerce because—

"(A) after manufacture, many controlled substances are transported in interstate commerce,

"(B) controlled substances distributed locally usually have been transported in interstate commerce immediately before their distribution, and

"(C) controlled substances possessed commonly flow through interstate commerce immediately prior to such possession.

concerned with the need to prevent the diversion of drugs from legitimate to illicit channels.[21]

To effectuate these goals, Congress devised a closed regulatory system making it unlawful to manufacture, distribute, dispense, or possess any controlled substance except in a manner authorized by the CSA. 21 U. S. C. §§841(a)(1), 844(a). The CSA categorizes all controlled substances into five schedules. §812. The drugs are grouped together based on their accepted medical uses, the potential for abuse, and their psychological and physical effects on the body. §§811, 812. Each schedule is associated with a distinct set of controls regarding the manufacture, distribution, and use of the substances listed therein. §§821–830. The CSA and its implementing regulations set forth strict requirements regarding registration, labeling and packaging, production quotas, drug security, and recordkeeping. *Ibid.* 21 CFR §1301 *et seq.* (2004).

In enacting the CSA, Congress classified marijuana as a Schedule I drug. 21 U. S. C. §812(c). This preliminary classification was based, in part, on the recommendation of the Assistant Secretary of HEW "that marihuana be retained within schedule I at least until the completion of

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"(4) Local distribution and possession of controlled substances contribute to swelling the interstate traffic in such substances.

"(5) Controlled substances manufactured and distributed intrastate cannot be differentiated from controlled substances manufactured and distributed interstate. Thus, it is not feasible to distinguish, in terms of controls, between controlled substances manufactured and distributed interstate and controlled substances manufactured and distributed intrastate.

"(6) Federal control of the intrastate incidents of the traffic in controlled substances is essential to the effective control of the interstate incidents of such traffic." 21 U. S. C. §§801(1)–(6).

[21] See *United States* v. *Moore,* 423 U. S. 122, 135 (1975); see also H. R. Rep., at 22.

certain studies now underway."[22] Schedule I drugs are categorized as such because of their high potential for abuse, lack of any accepted medical use, and absence of any accepted safety for use in medically supervised treatment. §812(b)(1). These three factors, in varying gradations, are also used to categorize drugs in the other four schedules. For example, Schedule II substances also have a high potential for abuse which may lead to severe psychological or physical dependence, but unlike Schedule I drugs, they have a currently accepted medical use. §812(b)(2). By classifying marijuana as a Schedule I drug, as opposed to listing it on a lesser schedule, the manufacture, distribution, or possession of marijuana became a criminal offense, with the sole exception being use of the drug as part of a Food and Drug Administration preapproved research study. §§823(f), 841(a)(1), 844(a); see also *United States* v. *Oakland Cannabis Buyers' Cooperative,* 532 U. S. 483, 490 (2001).

The CSA provides for the periodic updating of schedules and delegates authority to the Attorney General, after consultation with the Secretary of Health and Human Services, to add, remove, or transfer substances to, from, or between schedules. §811. Despite considerable efforts to reschedule marijuana, it remains a Schedule I drug.[23]

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[22] H. R. Rep., at 61 (quoting letter from Roger E. Egeberg, M. D. to Hon. Harley O. Staggers (Aug. 14, 1970)).

[23] Starting in 1972, the National Organization for the Reform of Marijuana Laws (NORML) began its campaign to reclassify marijuana. Grinspoon & Bakalar 13–17. After some fleeting success in 1988 when an Administrative Law Judge (ALJ) declared that the DEA would be acting in an "unreasonable, arbitrary, and capricious" manner if it continued to deny marijuana access to seriously ill patients, and concluded that it should be reclassified as a Schedule III substance, *Grinspoon* v. *DEA*, 828 F. 2d 881, 883–884 (CA1 1987), the campaign has proved unsuccessful. The DEA Administrator did not endorse the ALJ's findings, 54 Fed. Reg. 53767 (1989), and since that time has routinely denied petitions to reschedule the drug, most recently in

III

Respondents in this case do not dispute that passage of the CSA, as part of the Comprehensive Drug Abuse Prevention and Control Act, was well within Congress' commerce power. Brief for Respondents 22, 38. Nor do they contend that any provision or section of the CSA amounts to an unconstitutional exercise of congressional authority. Rather, respondents' challenge is actually quite limited; they argue that the CSA's categorical prohibition of the manufacture and possession of marijuana as applied to the intrastate manufacture and possession of marijuana for medical purposes pursuant to California law exceeds Congress' authority under the Commerce Clause.

In assessing the validity of congressional regulation, none of our Commerce Clause cases can be viewed in isolation. As charted in considerable detail in *United States* v. *Lopez*, our understanding of the reach of the Commerce Clause, as well as Congress' assertion of authority thereunder, has evolved over time.[24] The Commerce Clause emerged as the Framers' response to the central problem giving rise to the Constitution itself: the absence of any federal commerce power under the Articles of Confederation.[25] For the first century of our history, the primary use of the Clause was to preclude the kind of discriminatory state legislation that had once been per-

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2001. 66 Fed. Reg. 20038 (2001). The Court of Appeals for the District of Columbia Circuit has reviewed the petition to reschedule marijuana on five separate occasions over the course of 30 years, ultimately upholding the Administrator's final order. See *Alliance for Cannabis Therapeutics* v. *DEA*, 15 F. 3d 1131, 1133 (1994).

[24] *United States* v. *Lopez*, 514 U. S. 549, 552–558 (1995); *id.,* at 568–574 (KENNEDY, J., concurring); *id*., at 604–607 (SOUTER, J., dissenting).

[25] See *Gibbons* v. *Ogden,* 9 Wheat. 1, 224 (1824) (opinion of Johnson, J.); Stern, That Commerce Which Concerns More States Than One, 47 Harv. L. Rev. 1335, 1337, 1340–1341 (1934); G. Gunther, Constitutional Law 127 (9th ed. 1975).

missible.[26] Then, in response to rapid industrial development and an increasingly interdependent national economy, Congress "ushered in a new era of federal regulation under the commerce power," beginning with the enactment of the Interstate Commerce Act in 1887, 24 Stat. 379, and the Sherman Antitrust Act in 1890, 26 Stat. 209, as amended, 15 U. S. C. §2 *et seq.*[27]

Cases decided during that "new era," which now spans more than a century, have identified three general categories of regulation in which Congress is authorized to engage under its commerce power. First, Congress can regulate the channels of interstate commerce. *Perez* v. *United States,* 402 U. S. 146, 150 (1971). Second, Congress has authority to regulate and protect the instrumentalities of interstate commerce, and persons or things in interstate commerce. *Ibid.* Third, Congress has the power to regulate activities that substantially affect interstate commerce. *Ibid.; NLRB* v. *Jones & Laughlin Steel Corp.,* 301 U. S. 1, 37 (1937). Only the third category is implicated in the case at hand.

Our case law firmly establishes Congress' power to regulate purely local activities that are part of an economic "class of activities" that have a substantial effect on interstate commerce. See, *e.g., Perez*, 402 U. S., at 151;

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[26] See *Lopez,* 514 U. S., at 553–554; *id.,* at 568–569 (KENNEDY, J., concurring); see also *Granholm* v. *Heald*, 544 U. S. __, __ (2005) (slip op., at 8–9).

[27] *Lopez,* 514 U. S., at 554; see also *Wickard* v. *Filburn*, 317 U. S. 111, 121 (1942) ("It was not until 1887, with the enactment of the Interstate Commerce Act, that the interstate commerce power began to exert positive influence in American law and life. This first important federal resort to the commerce power was followed in 1890 by the Sherman Anti-Trust Act and, thereafter, mainly after 1903, by many others. These statutes ushered in new phases of adjudication, which required the Court to approach the interpretation of the Commerce Clause in the light of an actual exercise by Congress of its power thereunder" (footnotes omitted)).

Wickard v. *Filburn*, 317 U. S. 111, 128–129 (1942). As we stated in *Wickard*, "even if appellee's activity be local and though it may not be regarded as commerce, it may still, whatever its nature, be reached by Congress if it exerts a substantial economic effect on interstate commerce." *Id.*, at 125. We have never required Congress to legislate with scientific exactitude. When Congress decides that the "'total incidence'" of a practice poses a threat to a national market, it may regulate the entire class. See *Perez*, 402 U. S., at 154–155 (quoting *Westfall* v. *United States*, 274 U. S. 256, 259 (1927) ("[W]hen it is necessary in order to prevent an evil to make the law embrace more than the precise thing to be prevented it may do so")). In this vein, we have reiterated that when "'a general regulatory statute bears a substantial relation to commerce, the *de minimis* character of individual instances arising under that statute is of no consequence.'" *E.g., Lopez*, 514 U. S., at 558 (emphasis deleted) (quoting *Maryland* v. *Wirtz*, 392 U. S. 183, 196, n. 27 (1968)).

Our decision in *Wickard,* 317 U. S. 111, is of particular relevance. In *Wickard*, we upheld the application of regulations promulgated under the Agricultural Adjustment Act of 1938, 52 Stat. 31, which were designed to control the volume of wheat moving in interstate and foreign commerce in order to avoid surpluses and consequent abnormally low prices. The regulations established an allotment of 11.1 acres for Filburn's 1941 wheat crop, but he sowed 23 acres, intending to use the excess by consuming it on his own farm. Filburn argued that even though we had sustained Congress' power to regulate the production of goods for commerce, that power did not authorize "federal regulation [of] production not intended in any part for commerce but wholly for consumption on the farm." *Wickard,* 317 U. S., at 118. Justice Jackson's opinion for a unanimous Court rejected this submission. He wrote:

> "The effect of the statute before us is to restrict the amount which may be produced for market and the extent as well to which one may forestall resort to the market by producing to meet his own needs. That appellee's own contribution to the demand for wheat may be trivial by itself is not enough to remove him from the scope of federal regulation where, as here, his contribution, taken together with that of many others similarly situated, is far from trivial." *Id.*, at 127–128.

Wickard thus establishes that Congress can regulate purely intrastate activity that is not itself "commercial," in that it is not produced for sale, if it concludes that failure to regulate that class of activity would undercut the regulation of the interstate market in that commodity.

The similarities between this case and *Wickard* are striking. Like the farmer in *Wickard*, respondents are cultivating, for home consumption, a fungible commodity for which there is an established, albeit illegal, interstate market.[28] Just as the Agricultural Adjustment Act was designed "to control the volume [of wheat] moving in interstate and foreign commerce in order to avoid surpluses . . ." and consequently control the market price, *id.*, at 115, a primary purpose of the CSA is to control the supply and demand of controlled substances in both lawful and unlawful drug markets. See nn. 20–21, *supra*.

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[28] Even respondents acknowledge the existence of an illicit market in marijuana; indeed, Raich has personally participated in that market, and Monson expresses a willingness to do so in the future. App. 59, 74, 87. See also *Department of Revenue of Mont.* v. *Kurth Ranch*, 511 U. S. 767, 770, 774, n. 12, and 780, n. 17 (1994) (discussing the "market value" of marijuana); *id.*, at 790 (REHNQUIST, C. J., dissenting); *id.*, at 792 (O'CONNOR, J., dissenting); *Whalen* v. *Roe*, 429 U. S. 589, 591 (1977) (addressing prescription drugs "for which there is both a lawful and an unlawful market"); *Turner* v. *United States*, 396 U. S. 398, 417, n. 33 (1970) (referring to the purchase of drugs on the "retail market").

In *Wickard*, we had no difficulty concluding that Congress had a rational basis for believing that, when viewed in the aggregate, leaving home-consumed wheat outside the regulatory scheme would have a substantial influence on price and market conditions. Here too, Congress had a rational basis for concluding that leaving home-consumed marijuana outside federal control would similarly affect price and market conditions.

More concretely, one concern prompting inclusion of wheat grown for home consumption in the 1938 Act was that rising market prices could draw such wheat into the interstate market, resulting in lower market prices. *Wickard*, 317 U. S., at 128. The parallel concern making it appropriate to include marijuana grown for home consumption in the CSA is the likelihood that the high demand in the interstate market will draw such marijuana into that market. While the diversion of homegrown wheat tended to frustrate the federal interest in stabilizing prices by regulating the volume of commercial transactions in the interstate market, the diversion of homegrown marijuana tends to frustrate the federal interest in eliminating commercial transactions in the interstate market in their entirety. In both cases, the regulation is squarely within Congress' commerce power because production of the commodity meant for home consumption, be it wheat or marijuana, has a substantial effect on supply and demand in the national market for that commodity.[29]

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[29] To be sure, the wheat market is a lawful market that Congress sought to protect and stabilize, whereas the marijuana market is an unlawful market that Congress sought to eradicate. This difference, however, is of no constitutional import. It has long been settled that Congress' power to regulate commerce includes the power to prohibit commerce in a particular commodity. *Lopez,* 514 U. S., at 571 (KENNEDY, J., concurring) ("In the *Lottery Case*, 188 U. S. 321 (1903), the Court rejected the argument that Congress lacked [the] power to prohibit the interstate movement of lottery tickets because it had power only to regulate, not to prohibit"); see also *Wickard*, 317 U. S., at 128 ("The

Nonetheless, respondents suggest that *Wickard* differs from this case in three respects: (1) the Agricultural Adjustment Act, unlike the CSA, exempted small farming operations; (2) *Wickard* involved a "quintessential economic activity"—a commercial farm—whereas respondents do not sell marijuana; and (3) the *Wickard* record made it clear that the aggregate production of wheat for use on farms had a significant impact on market prices. Those differences, though factually accurate, do not diminish the precedential force of this Court's reasoning.

The fact that Wickard's own impact on the market was "trivial by itself" was not a sufficient reason for removing him from the scope of federal regulation. 317 U. S., at 127. That the Secretary of Agriculture elected to exempt even smaller farms from regulation does not speak to his power to regulate all those whose aggregated production was significant, nor did that fact play any role in the Court's analysis. Moreover, even though Wickard was indeed a commercial farmer, the activity he was engaged in—the cultivation of wheat for home consumption—was not treated by the Court as part of his commercial farming operation.[30] And while it is true that the record in the *Wickard* case itself established the causal connection between the production for local use and the national market, we have before us findings by Congress to the same effect.

Findings in the introductory sections of the CSA explain why Congress deemed it appropriate to encompass local activities within the scope of the CSA. See n. 20, *supra*. The submissions of the parties and the numerous *amici* all seem to agree that the national, and international, market

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stimulation of commerce is a use of the regulatory function quite as definitely as prohibitions or restrictions thereon").

[30] See *Wickard,* 317 U. S., at 125 (recognizing that Wickard's activity "may not be regarded as commerce").

for marijuana has dimensions that are fully comparable to those defining the class of activities regulated by the Secretary pursuant to the 1938 statute.[31] Respondents nonetheless insist that the CSA cannot be constitutionally applied to their activities because Congress did not make a specific finding that the intrastate cultivation and possession of marijuana for medical purposes based on the recommendation of a physician would substantially affect the larger interstate marijuana market. Be that as it may, we have never required Congress to make particularized findings in order to legislate, see *Lopez*, 514 U. S., at 562; *Perez*, 402 U. S., at 156, absent a special concern such as the protection of free speech, see, *e.g., Turner Broadcasting System, Inc.* v. *FCC*, 512 U. S. 622, 664–668 (1994) (plurality opinion). While congressional findings are certainly helpful in reviewing the substance of a congressional statutory scheme, particularly when the connection to commerce is not self-evident, and while we will consider congressional findings in our analysis when they are available, the absence of particularized findings does not call into question Congress' authority to legislate.[32]

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[31] The Executive Office of the President has estimated that in 2000 American users spent $10.5 *billion* on the purchase of marijuana. Office of Nat. Drug Control Policy, Marijuana Fact Sheet 5 (Feb. 2004), available at http://www.whitehousedrugpolicy.gov/publications/factsht/marijuana/index.html (all Internet materials as visited June 2, 2005, and available in Clerk of Court's case file).

[32] Moreover, as discussed in more detail above, Congress did make findings regarding the effects of intrastate drug activity on interstate commerce. See n. 20, *supra*. Indeed, even the Court of Appeals found that those findings "weigh[ed] in favor" of upholding the constitutionality of the CSA. 352 F. 3d 1222, 1232 (CA9 2003) (case below). The dissenters, however, would impose a new and heightened burden on Congress (unless the litigants can garner evidence sufficient to cure Congress' perceived "inadequa[cies]")—that legislation must contain detailed findings proving that each activity regulated within a comprehensive statute is essential to the statutory scheme. *Post,* at 13–15 (O'CONNOR, J., dissenting); *post*, at 8 (THOMAS, J., dissenting). Such an

In assessing the scope of Congress' authority under the Commerce Clause, we stress that the task before us is a modest one. We need not determine whether respondents' activities, taken in the aggregate, substantially affect interstate commerce in fact, but only whether a "rational basis" exists for so concluding. *Lopez*, 514 U. S., at 557; see also *Hodel* v. *Virginia Surface Mining & Reclamation Assn., Inc.,* 452 U. S. 264, 276–280 (1981); *Perez*, 402 U. S., at 155–156; *Katzenbach* v. *McClung*, 379 U. S. 294, 299–301 (1964); *Heart of Atlanta Motel, Inc.* v. *United States*, 379 U. S. 241, 252–253 (1964). Given the enforcement difficulties that attend distinguishing between marijuana cultivated locally and marijuana grown elsewhere, 21 U. S. C. §801(5), and concerns about diversion into illicit channels,[33] we have no difficulty concluding that Congress had a rational basis for believing that failure to regulate the intrastate manufacture and possession of marijuana would leave a gaping hole in the CSA. Thus, as in *Wickard*, when it enacted comprehensive legislation to regulate the interstate market in a fungible commodity, Congress was acting well within its authority to "make all Laws which shall be necessary and proper" to "regulate Commerce . . . among the several States." U. S. Const., Art. I, §8. That the regulation ensnares some purely intrastate activity is of no moment. As we have done many times before, we refuse to excise individual compo-

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exacting requirement is not only unprecedented, it is also impractical. Indeed, the principal dissent's critique of Congress for "not even" including "declarations" specific to marijuana is particularly unpersuasive given that the CSA initially identified 80 other substances subject to regulation as Schedule I drugs, not to mention those categorized in Schedules II–V. *Post*, at 14 (O'CONNOR, J., dissenting). Surely, Congress cannot be expected (and certainly should not be required) to include specific findings on each and every substance contained therein in order to satisfy the dissenters' unfounded skepticism.

[33] See n. 21, *supra* (citing sources that evince Congress' particular concern with the diversion of drugs from legitimate to illicit channels).

nents of that larger scheme.

IV

To support their contrary submission, respondents rely heavily on two of our more recent Commerce Clause cases. In their myopic focus, they overlook the larger context of modern-era Commerce Clause jurisprudence preserved by those cases. Moreover, even in the narrow prism of respondents' creation, they read those cases far too broadly.

Those two cases, of course, are *Lopez*, 514 U. S. 549, and *Morrison*, 529 U. S. 598. As an initial matter, the statutory challenges at issue in those cases were markedly different from the challenge respondents pursue in the case at hand. Here, respondents ask us to excise individual applications of a concededly valid statutory scheme. In contrast, in both *Lopez* and *Morrison*, the parties asserted that a particular statute or provision fell outside Congress' commerce power in its entirety. This distinction is pivotal for we have often reiterated that "[w]here the class of activities is regulated and that class is within the reach of federal power, the courts have no power 'to excise, as trivial, individual instances' of the class." *Perez,* 402 U. S., at 154 (emphasis deleted) (quoting *Wirtz*, 392 U. S., at 193); see also *Hodel,* 452 U. S., at 308.

At issue in *Lopez*, 514 U. S. 549, was the validity of the Gun-Free School Zones Act of 1990, which was a brief, single-subject statute making it a crime for an individual to possess a gun in a school zone. 104 Stat. 4844–4845, 18 U. S. C. §922(q)(1)(A). The Act did not regulate any economic activity and did not contain any requirement that the possession of a gun have any connection to past interstate activity or a predictable impact on future commercial activity. Distinguishing our earlier cases holding that comprehensive regulatory statutes may be validly applied to local conduct that does not, when viewed in isolation, have a significant impact on interstate commerce, we held

the statute invalid. We explained:

> "Section 922(q) is a criminal statute that by its terms has nothing to do with 'commerce' or any sort of economic enterprise, however broadly one might define those terms. Section 922(q) is not an essential part of a larger regulation of economic activity, in which the regulatory scheme could be undercut unless the intrastate activity were regulated. It cannot, therefore, be sustained under our cases upholding regulations of activities that arise out of or are connected with a commercial transaction, which viewed in the aggregate, substantially affects interstate commerce." 514 U. S., at 561.

The statutory scheme that the Government is defending in this litigation is at the opposite end of the regulatory spectrum. As explained above, the CSA, enacted in 1970 as part of the Comprehensive Drug Abuse Prevention and Control Act, 84 Stat. 1242–1284, was a lengthy and detailed statute creating a comprehensive framework for regulating the production, distribution, and possession of five classes of "controlled substances." Most of those substances—those listed in Schedules II through V—"have a useful and legitimate medical purpose and are necessary to maintain the health and general welfare of the American people." 21 U. S. C. §801(1). The regulatory scheme is designed to foster the beneficial use of those medications, to prevent their misuse, and to prohibit entirely the possession or use of substances listed in Schedule I, except as a part of a strictly controlled research project.

While the statute provided for the periodic updating of the five schedules, Congress itself made the initial classifications. It identified 42 opiates, 22 opium derivatives, and 17 hallucinogenic substances as Schedule I drugs. 84 Stat. 1248. Marijuana was listed as the 10th item in the third subcategory. That classification, unlike the discrete pro-

hibition established by the Gun-Free School Zones Act of 1990, was merely one of many "essential part[s] of a larger regulation of economic activity, in which the regulatory scheme could be undercut unless the intrastate activity were regulated." *Lopez*, 514 U. S., at 561.[34] Our opinion in *Lopez* casts no doubt on the validity of such a program.

Nor does this Court's holding in *Morrison*, 529 U. S. 598. The Violence Against Women Act of 1994, 108 Stat. 1902, created a federal civil remedy for the victims of gender-motivated crimes of violence. 42 U. S. C. §13981. The remedy was enforceable in both state and federal courts, and generally depended on proof of the violation of a state law. Despite congressional findings that such crimes had an adverse impact on interstate commerce, we held the statute unconstitutional because, like the statute in *Lopez*, it did not regulate economic activity. We concluded that "the noneconomic, criminal nature of the conduct at issue was central to our decision" in *Lopez*, and that our prior cases had identified a clear pattern of analysis: "'Where economic activity substantially affects interstate commerce, legislation regulating that activity will be sustained.'"[35] *Morrison*, 529 U. S., at 610.

Unlike those at issue in *Lopez* and *Morrison*, the activi-

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[34] The principal dissent asserts that by "[s]eizing upon our language in *Lopez*," *post*, at 5 (opinion of O'CONNOR, J.), *i.e.,* giving effect to our well-established case law, Congress will now have an incentive to legislate broadly. Even putting aside the political checks that would generally curb Congress' power to enact a broad and comprehensive scheme for the purpose of targeting purely local activity, there is no suggestion that the CSA constitutes the type of "evasive" legislation the dissent fears, nor could such an argument plausibly be made. *Post*, at 6 (O'CONNOR, J., dissenting).

[35] *Lopez,* 514 U. S., at 560; see also *id.*, at 573–574 (KENNEDY, J., concurring) (stating that *Lopez* did not alter our "practical conception of commercial regulation" and that Congress may "regulate in the commercial sphere on the assumption that we have a single market and a unified purpose to build a stable national economy").

ties regulated by the CSA are quintessentially economic. "Economics" refers to "the production, distribution, and consumption of commodities." Webster's Third New International Dictionary 720 (1966). The CSA is a statute that regulates the production, distribution, and consumption of commodities for which there is an established, and lucrative, interstate market. Prohibiting the intrastate possession or manufacture of an article of commerce is a rational (and commonly utilized) means of regulating commerce in that product.[36] Such prohibitions include specific decisions requiring that a drug be withdrawn from the market as a result of the failure to comply with regulatory requirements as well as decisions excluding Schedule I drugs entirely from the market. Because the CSA is a statute that directly regulates economic, commercial activity, our opinion in *Morrison* casts no doubt on its constitutionality.

The Court of Appeals was able to conclude otherwise only by isolating a "separate and distinct" class of activities that it held to be beyond the reach of federal power, defined as "the intrastate, noncommercial cultivation, possession and use of marijuana for personal medical purposes on the advice of a physician and in accordance with state law." 352 F. 3d, at 1229. The court characterized this class as "different in kind from drug trafficking." *Id.,* at 1228. The differences between the members of a class so defined and the principal traffickers in Schedule I substances might be sufficient to justify a policy decision exempting the narrower class from the coverage of the CSA. The question, however, is whether Congress' contrary policy judgment, *i.e.*, its decision to include this narrower "class of activities" within the larger regulatory

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[36] See 16 U. S. C. §668(a) (bald and golden eagles); 18 U. S. C. §175(a) (biological weapons); §831(a) (nuclear material); §842(n)(1) (certain plastic explosives); §2342(a) (contraband cigarettes).

scheme, was constitutionally deficient. We have no difficulty concluding that Congress acted rationally in determining that none of the characteristics making up the purported class, whether viewed individually or in the aggregate, compelled an exemption from the CSA; rather, the subdivided class of activities defined by the Court of Appeals was an essential part of the larger regulatory scheme.

First, the fact that marijuana is used "for personal medical purposes on the advice of a physician" cannot itself serve as a distinguishing factor. 352 F. 3d, at 1229. The CSA designates marijuana as contraband for *any* purpose; in fact, by characterizing marijuana as a Schedule I drug, Congress expressly found that the drug has no acceptable medical uses. Moreover, the CSA is a comprehensive regulatory regime specifically designed to regulate which controlled substances can be utilized for medicinal purposes, and in what manner. Indeed, most of the substances classified in the CSA "have a useful and legitimate medical purpose." 21 U. S. C. §801(1). Thus, even if respondents are correct that marijuana does have accepted medical uses and thus should be redesignated as a lesser schedule drug,[37] the CSA would still impose controls

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[37] We acknowledge that evidence proffered by respondents in this case regarding the effective medical uses for marijuana, if found credible after trial, would cast serious doubt on the accuracy of the findings that require marijuana to be listed in Schedule I. See, *e.g.,* Institute of Medicine, Marijuana and Medicine: Assessing the Science Base 179 (J. Joy, S. Watson, & J. Benson eds. 1999) (recognizing that "[s]cientific data indicate the potential therapeutic value of cannabinoid drugs, primarily THC [Tetrahydrocannabinol] for pain relief, control of nausea and vomiting, and appetite stimulation"); see also *Conant* v. *Walters*, 309 F. 3d 629, 640–643 (CA9 2002) (Kozinski, J., concurring) (chronicling medical studies recognizing valid medical uses for marijuana and its derivatives). But the possibility that the drug may be reclassified in the future has no relevance to the question whether Congress now has the power to regulate its production and distribution. Respondents'

beyond what is required by California law. The CSA requires manufacturers, physicians, pharmacies, and other handlers of controlled substances to comply with statutory and regulatory provisions mandating registration with the DEA, compliance with specific production quotas, security controls to guard against diversion, recordkeeping and reporting obligations, and prescription requirements. See 21 U. S. C. §§821–830; 21 CFR §1301 *et seq*. (2004). Furthermore, the dispensing of new drugs, even when doctors approve their use, must await federal approval. *United States* v. *Rutherford*, 442 U. S. 544 (1979). Accordingly, the mere fact that marijuana—like virtually every other controlled substance regulated by the CSA—is used for medicinal purposes cannot possibly serve to distinguish it from the core activities regulated by the CSA.

Nor can it serve as an "objective marke[r]" or "objective facto[r]" to arbitrarily narrow the relevant class as the dissenters suggest, *post*, at 6 (O'CONNOR, J., dissenting); *post*, at 12 (THOMAS, J., dissenting). More fundamentally, if, as the principal dissent contends, the personal cultivation, possession, and use of marijuana for medicinal purposes is beyond the " 'outer limits' of Congress' Commerce Clause authority," *post*, at 1 (O'CONNOR, J., dissenting), it must also be true that such personal use of marijuana (or any other homegrown drug) for recreational purposes is also beyond those " 'outer limits,' " whether or not a State elects to authorize or even regulate such use. JUSTICE THOMAS' separate dissent suffers from the same sweeping implications. That is, the dissenters' rationale logically extends to place *any* federal regulation (including quality, prescription, or quantity controls) of *any* locally cultivated and possessed controlled substance for *any* purpose be-

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submission, if accepted, would place all homegrown medical substances beyond the reach of Congress' regulatory jurisdiction.

yond the " 'outer limits' " of Congress' Commerce Clause authority. One need not have a degree in economics to understand why a nationwide exemption for the vast quantity of marijuana (or other drugs) locally cultivated for personal use (which presumably would include use by friends, neighbors, and family members) may have a substantial impact on the interstate market for this extraordinarily popular substance. The congressional judgment that an exemption for such a significant segment of the total market would undermine the orderly enforcement of the entire regulatory scheme is entitled to a strong presumption of validity. Indeed, that judgment is not only rational, but "visible to the naked eye," *Lopez*, 514 U. S., at 563, under any commonsense appraisal of the probable consequences of such an open-ended exemption.

Second, limiting the activity to marijuana possession and cultivation "in accordance with state law" cannot serve to place respondents' activities beyond congressional reach. The Supremacy Clause unambiguously provides that if there is any conflict between federal and state law, federal law shall prevail. It is beyond peradventure that federal power over commerce is " 'superior to that of the States to provide for the welfare or necessities of their inhabitants,' " however legitimate or dire those necessities may be. *Wirtz*, 392 U. S., at 196 (quoting *Sanitary Dist. of Chicago* v. *United States*, 266 U. S. 405, 426 (1925)). See also 392 U. S., at 195–196; *Wickard*, 317 U. S., at 124 (" '[N]o form of state activity can constitutionally thwart the regulatory power granted by the commerce clause to Congress' "). Just as state acquiescence to federal regulation cannot expand the bounds of the Commerce Clause, see, *e.g.*, *Morrison*, 529 U. S., at 661–662 (BREYER, J., dissenting) (noting that 38 States requested federal intervention), so too state action cannot circumscribe Congress' plenary commerce power. See *United States* v. *Darby*, 312 U. S. 100, 114 (1941) ("That power can neither be enlarged

nor diminished by the exercise or non-exercise of state power").[38]

Respondents acknowledge this proposition, but nonetheless contend that their activities were not "an essential part of a larger regulatory scheme" because they had been "isolated by the State of California, and [are] policed by the State of California," and thus remain "entirely separated from the market." Tr. of Oral Arg. 27. The dissenters fall prey to similar reasoning. See n. 38, *supra* this page. The notion that California law has surgically ex-

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[38] That is so even if California's current controls (enacted eight years after the Compassionate Use Act was passed) are "[e]ffective," as the dissenters would have us blindly presume, *post*, at 15 (O'CONNOR, J., dissenting); *post*, at 6, 12 (THOMAS, J., dissenting). California's decision (made 34 years after the CSA was enacted) to impose "stric[t] controls" on the "cultivation and possession of marijuana for medical purposes," *post*, at 6 (THOMAS, J., dissenting), cannot retroactively divest Congress of its authority under the Commerce Clause. Indeed, JUSTICE THOMAS' urgings to the contrary would turn the Supremacy Clause on its head, and would resurrect limits on congressional power that have long since been rejected. See *post*, at 8 (SCALIA, J., concurring in judgment) (quoting *McCulloch* v. *Maryland,* 4 Wheat. 316, 424 (1819)) ("'To impose on [Congress] the necessity of resorting to means which it cannot control, which another government may furnish or withhold, would render its course precarious, the result of its measures uncertain, and create a dependence on other governments, which might disappoint its most important designs, and is incompatible with the language of the constitution'").

Moreover, in addition to casting aside more than a century of this Court's Commerce Clause jurisprudence, it is noteworthy that JUSTICE THOMAS' suggestion that States possess the power to dictate the extent of Congress' commerce power would have far-reaching implications beyond the facts of this case. For example, under his reasoning, Congress would be equally powerless to regulate, let alone prohibit, the intrastate possession, cultivation, and use of marijuana for *recreational* purposes, an activity which all States "strictly contro[l]." Indeed, his rationale seemingly would require Congress to cede its constitutional power to regulate commerce whenever a State opts to exercise its "traditional police powers to define the criminal law and to protect the health, safety, and welfare of their citizens." *Post*, at 9–10 (dissenting opinion).

cised a discrete activity that is hermetically sealed off from the larger interstate marijuana market is a dubious proposition, and, more importantly, one that Congress could have rationally rejected.

Indeed, that the California exemptions will have a significant impact on both the supply and demand sides of the market for marijuana is not just "plausible" as the principal dissent concedes, *post*, at 16 (O'CONNOR, J., dissenting), it is readily apparent. The exemption for physicians provides them with an economic incentive to grant their patients permission to use the drug. In contrast to most prescriptions for legal drugs, which limit the dosage and duration of the usage, under California law the doctor's permission to recommend marijuana use is open-ended. The authority to grant permission whenever the doctor determines that a patient is afflicted with "any other illness for which marijuana provides relief," Cal. Health & Safety Code Ann. §11362.5(b)(1)(A) (West Supp. 2005), is broad enough to allow even the most scrupulous doctor to conclude that some recreational uses would be therapeutic.[39] And our cases have taught us that there are some unscrupulous physicians who overprescribe when it is sufficiently profitable to do so.[40]

The exemption for cultivation by patients and caregivers can only increase the supply of marijuana in the California market.[41] The likelihood that all such production will

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[39] California's Compassionate Use Act has since been amended, limiting the catchall category to "[a]ny other chronic or persistent medical symptom that either: . . . [s]ubstantially limits the ability of the person to conduct one or more major life activities as defined" in the Americans with Disabilities Act of 1990, or "[i]f not alleviated, may cause serious harm to the patient's safety or physical or mental health." Cal. Health & Safety Code Ann. §§11362.7(h)(12)(A) to (12)(B) (West Supp. 2005).

[40] See, *e.g., United States* v. *Moore,* 423 U. S. 122 (1975); *United States* v. *Doremus*, 249 U. S. 86 (1919).

[41] The state policy allows patients to possess up to eight ounces of

promptly terminate when patients recover or will precisely match the patients' medical needs during their convalescence seems remote; whereas the danger that excesses will satisfy some of the admittedly enormous demand for recreational use seems obvious.[42] Moreover, that the national and international narcotics trade has thrived in the face of vigorous criminal enforcement efforts suggests that no small number of unscrupulous people will make use of the California exemptions to serve their commercial ends whenever it is feasible to do so.[43] Taking into account the fact that

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dried marijuana, and to cultivate up to 6 mature or 12 immature plants. Cal. Health & Safety Code Ann. §11362.77(a) (West Supp. 2005). However, the quantity limitations serve only as a floor. Based on a doctor's recommendation, a patient can possess whatever quantity is necessary to satisfy his medical needs, and cities and counties are given *carte blanche* to establish more generous limits. Indeed, several cities and counties have done just that. For example, patients residing in the cities of Oakland and Santa Cruz and in the counties of Sonoma and Tehama are permitted to possess up to 3 pounds of processed marijuana. Reply Brief for United States 19 (citing Proposition 215 Enforcement Guidelines). Putting that quantity in perspective, 3 pounds of marijuana yields roughly 3,000 joints or cigarettes. Executive Office of the President, Office of National Drug Control Policy, What America's Users Spend on Illegal Drugs 24 (Dec. 2001), http://www.whitehousedrugpolicy.gov/publications/pdf/american_users_spend_2002.pdf. And the street price for that amount can range anywhere from $900 to $24,000. DEA, Illegal Drug Price and Purity Report (Apr. 2003) (DEA–02058).

[42] For example, respondent Raich attests that she uses 2.5 ounces of cannabis a week. App. 82. Yet as a resident of Oakland, she is entitled to possess up to 3 pounds of processed marijuana at any given time, nearly 20 times more than she uses on a weekly basis.

[43] See, *e.g., People ex rel. Lungren* v. *Peron*, 59 Cal. App. 4th 1383, 1386–1387 (1997) (recounting how a Cannabis Buyers' Club engaged in an "indiscriminate and uncontrolled pattern of sale to thousands of persons among the general public, including persons who had not demonstrated any recommendation or approval of a physician and, in fact, some of whom were not under the care of a physician, such as undercover officers," and noting that "some persons who had purchased marijuana on respondents' premises were reselling it unlawfully on the

California is only one of at least nine States to have authorized the medical use of marijuana, a fact JUSTICE O'CONNOR's dissent conveniently disregards in arguing that the demonstrated effect on commerce while admittedly "plausible" is ultimately "unsubstantiated," *post,* at 14, 16, Congress could have rationally concluded that the aggregate impact on the national market of all the transactions exempted from federal supervision is unquestionably substantial.

So, from the "separate and distinct" class of activities identified by the Court of Appeals (and adopted by the dissenters), we are left with "the intrastate, noncommercial cultivation, possession and use of marijuana." 352 F. 3d, at 1229. Thus the case for the exemption comes down to the claim that a locally cultivated product that is used domestically rather than sold on the open market is not subject to federal regulation. Given the findings in the CSA and the undisputed magnitude of the commercial market for marijuana, our decisions in *Wickard* v. *Filburn* and the later cases endorsing its reasoning foreclose that claim.

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Respondents also raise a substantive due process claim and seek to avail themselves of the medical necessity defense. These theories of relief were set forth in their complaint but were not reached by the Court of Appeals. We therefore do not address the question whether judicial relief is available to respondents on these alternative bases. We do note, however, the presence of another avenue of relief. As the Solicitor General confirmed during oral argument, the statute authorizes procedures for the reclassification of Schedule I drugs. But perhaps even more important than these legal avenues is the democratic

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street").

process, in which the voices of voters allied with these respondents may one day be heard in the halls of Congress. Under the present state of the law, however, the judgment of the Court of Appeals must be vacated. The case is remanded for further proceedings consistent with this opinion.

It is so ordered.

U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General *Washington, D.C. 20530*

February 14, 2014

MEMORANDUM FOR ALL UNITED STATES ATTORNEYS

FROM: James M. Cole
Deputy Attorney General

SUBJECT: Guidance Regarding Marijuana Related Financial Crimes

On August 29, 2013, the Department issued guidance (August 29 guidance) to federal prosecutors concerning marijuana enforcement under the Controlled Substances Act (CSA). The August 29 guidance reiterated the Department's commitment to enforcing the CSA consistent with Congress' determination that marijuana is a dangerous drug that serves as a significant source of revenue to large-scale criminal enterprises, gangs, and cartels. In furtherance of that commitment, the August 29 guidance instructed Department attorneys and law enforcement to focus on the following eight priorities in enforcing the CSA against marijuana-related conduct:

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
- Preventing state-authorized marijuana 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 marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.

Under the August 29 guidance, whether marijuana-related conduct implicates one or more of these enforcement priorities should be the primary question in considering prosecution

under the CSA. Although the August 29 guidance was issued in response to recent marijuana legalization initiatives in certain states, it applies to all Department marijuana enforcement nationwide. The guidance, however, did not specifically address what, if any, impact it would have on certain financial crimes for which marijuana-related conduct is a predicate.

The provisions of the money laundering statutes, the unlicensed money remitter statute, and the Bank Secrecy Act (BSA) remain in effect with respect to marijuana-related conduct. Financial transactions involving proceeds generated by marijuana-related conduct can form the basis for prosecution under the money laundering statutes (18 U.S.C. §§ 1956 and 1957), the unlicensed money transmitter statute (18 U.S.C. § 1960), and the BSA. Sections 1956 and 1957 of Title 18 make it a criminal offense to engage in certain financial and monetary transactions with the proceeds of a "specified unlawful activity," including proceeds from marijuana-related violations of the CSA. Transactions by or through a money transmitting business involving funds "derived from" marijuana-related conduct can also serve as a predicate for prosecution under 18 U.S.C. § 1960. Additionally, financial institutions that conduct transactions with money generated by marijuana-related conduct could face criminal liability under the BSA for, among other things, failing to identify or report financial transactions that involved the proceeds of marijuana-related violations of the CSA. *See, e.g.*, 31 U.S.C. § 5318(g). Notably for these purposes, prosecution under these offenses based on transactions involving marijuana proceeds does not require an underlying marijuana-related conviction under federal or state law.

As noted in the August 29 guidance, the Department is committed to using its limited investigative and prosecutorial resources to address the most significant marijuana-related cases in an effective and consistent way. Investigations and prosecutions of the offenses enumerated above based upon marijuana-related activity should be subject to the same consideration and prioritization. Therefore, in determining whether to charge individuals or institutions with any of these offenses based on marijuana-related violations of the CSA, prosecutors should apply the eight enforcement priorities described in the August 29 guidance and reiterated above. [1] For example, if a financial institution or individual provides banking services to a marijuana-related business knowing that the business is diverting marijuana from a state where marijuana sales are regulated to ones where such sales are illegal under state law, or is being used by a criminal organization to conduct financial transactions for its criminal goals, such as the concealment of funds derived from other illegal activity or the use of marijuana proceeds to support other illegal activity, prosecution for violations of 18 U.S.C. §§ 1956, 1957, 1960 or the BSA might be appropriate. Similarly, if the financial institution or individual is willfully blind to such activity by, for example, failing to conduct appropriate due diligence of the customers' activities, such prosecution might be appropriate. Conversely, if a financial institution or individual offers

[1] The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) is issuing concurrent guidance to clarify BSA expectations for financial institutions seeking to provide services to marijuana-related businesses. The FinCEN guidance addresses the filing of Suspicious Activity Reports (SAR) with respect to marijuana-related businesses, and in particular the importance of considering the eight federal enforcement priorities mentioned above, as well as state law. As discussed in FinCEN's guidance, a financial institution providing financial services to a marijuana-related business that it reasonably believes, based on its customer due diligence, does not implicate one of the federal enforcement priorities or violate state law, would file a "Marijuana Limited" SAR, which would include streamlined information. Conversely, a financial institution filing a SAR on a marijuana-related business it reasonably believes, based on its customer due diligence, implicates one of the federal priorities or violates state law, would be label the SAR "Marijuana Priority," and the content of the SAR would include comprehensive details in accordance with existing regulations and guidance.

services to a marijuana-related business whose activities do not implicate any of the eight priority factors, prosecution for these offenses may not be appropriate.

The August 29 guidance rested on the expectation that states that have enacted laws authorizing marijuana-related conduct will implement clear, strong and effective regulatory and enforcement systems in order to minimize the threat posed to federal enforcement priorities. Consequently, financial institutions and individuals choosing to service marijuana-related businesses that are not compliant with such state regulatory and enforcement systems, or that operate in states lacking a clear and robust regulatory scheme, are more likely to risk entanglement with conduct that implicates the eight federal enforcement priorities.[2] In addition, because financial institutions are in a position to facilitate transactions by marijuana-related businesses that could implicate one or more of the priority factors, financial institutions must continue to apply appropriate risk-based anti-money laundering policies, procedures, and controls sufficient to address the risks posed by these customers, including by conducting customer due diligence designed to identify conduct that relates to any of the eight priority factors. Moreover, as the Department's and FinCEN's guidance are designed to complement each other, it is essential that financial institutions adhere to FinCEN's guidance.[3] Prosecutors should continue to review marijuana-related prosecutions on a case-by-case basis and weigh all available information and evidence in determining whether particular conduct falls within the identified priorities.

As with the Department's previous statements on this subject, this memorandum is intended solely as a guide to the exercise of investigative and prosecutorial discretion. This memorandum does not alter in any way the Department's authority to enforce federal law, including federal laws relating to marijuana, regardless of state law. Neither the guidance herein nor any state or local law provides a legal defense to a violation of federal law, including any civil or criminal violation of the CSA, the money laundering and unlicensed money transmitter statutes, or the BSA, including the obligation of financial institutions to conduct customer due diligence. Even in jurisdictions with strong and effective regulatory systems, evidence that particular conduct of a person or entity threatens federal priorities will subject that person or entity to federal enforcement action, based on the circumstances. This memorandum is not intended, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal. It applies prospectively to the exercise of prosecutorial discretion in future cases and does not provide defendants or subjects of enforcement action with a basis for reconsideration of any pending civil action or criminal prosecution. Finally, nothing herein precludes investigation or prosecution, even in the absence of any one of the factors listed above, in particular circumstances where investigation and prosecution otherwise serves an important federal interest.

[2] For example, financial institutions should recognize that a marijuana-related business operating in a state that has not legalized marijuana would likely result in the proceeds going to a criminal organization.
[3] Under FinCEN's guidance, for instance, a marijuana-related business that is not appropriately licensed or is operating in violation of state law presents red flags that would justify the filing of a Marijuana Priority SAR.

Office of the Attorney General
Washington, D. C. 20530

January 4, 2018

MEMORANDUM FOR ALL UNITED STATES ATTORNEYS

FROM: Jefferson B. Sessions, III
Attorney General

SUBJECT: Marijuana Enforcement

In the Controlled Substances Act, Congress has generally prohibited the cultivation, distribution, and possession of marijuana. 21 U.S.C. § 801 *et seq*. It has established significant penalties for these crimes. 21 U.S.C. § 841 *et seq*. These activities also may serve as the basis for the prosecution of other crimes, such as those prohibited by the money laundering statutes, the unlicensed money transmitter statute, and the Bank Secrecy Act. 18 U.S.C. §§ 1956-57, 1960; 31 U.S.C. § 5318. These statutes reflect Congress's determination that marijuana is a dangerous drug and that marijuana activity is a serious crime.

In deciding which marijuana activities to prosecute under these laws with the Department's finite resources, prosecutors should follow the well-established principles that govern all federal prosecutions. Attorney General Benjamin Civiletti originally set forth these principles in 1980, and they have been refined over time, as reflected in chapter 9-27.000 of the U.S. Attorneys' Manual. These principles require federal prosecutors deciding which cases to prosecute to weigh all relevant considerations, including federal law enforcement priorities set by the Attorney General, the seriousness of the crime, the deterrent effect of criminal prosecution, and the cumulative impact of particular crimes on the community.

Given the Department's well-established general principles, previous nationwide guidance specific to marijuana enforcement is unnecessary and is rescinded, effective immediately.[1] This memorandum is intended solely as a guide to the exercise of investigative and prosecutorial discretion in accordance with all applicable laws, regulations, and appropriations. It is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.

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[1] Previous guidance includes: David W. Ogden, Deputy Att'y Gen., Memorandum for Selected United States Attorneys: Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana (Oct. 19, 2009); James M. Cole, Deputy Att'y Gen., Memorandum for United States Attorneys: Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (June 29, 2011); James M. Cole, Deputy Att'y Gen., Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement (Aug. 29, 2013); James M. Cole, Deputy Att'y Gen., Memorandum for All United States Attorneys: Guidance Regarding Marijuana Related Financial Crimes (Feb. 14, 2014); and Monty Wilkinson, Director of the Executive Office for U.S. Att'ys, Policy Statement Regarding Marijuana Issues in Indian Country (Oct. 28, 2014).

BANK SECRECY ACT, ANTI-MONEY LAUNDERING, AND OFFICE OF FOREIGN ASSETS CONTROL

INTRODUCTION TO THE BANK SECRECY ACT

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 (31 U.S.C. 5311 et seq.) is referred to as the Bank Secrecy Act (BSA). The purpose of the BSA is to require United States (U.S.) financial institutions to maintain appropriate records and file certain reports involving currency transactions and a financial institution's customer relationships. Currency Transaction Reports (CTRs) and Suspicious Activity Reports (SARs) are the primary means used by banks to satisfy the requirements of the BSA. The recordkeeping regulations also include the requirement that a financial institution's records be sufficient to enable transactions and activity in customer accounts to be reconstructed if necessary. In doing so, a paper and audit trail is maintained. These records and reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.

The BSA consists of two parts: Title I Financial Recordkeeping and Title II Reports of Currency and Foreign Transactions. Title I authorizes the Secretary of the Department of the Treasury (Treasury) to issue regulations, which require insured financial institutions to maintain certain records. Title II directed the Treasury to prescribe regulations governing the reporting of certain transactions by and through financial institutions in excess of $10,000 into, out of, and within the U.S. The Treasury's implementing regulations under the BSA, issued within the provisions of 31 CFR Part 103, are included in the FDIC's Rules and Regulations and on the FDIC website.

The implementing regulations under the BSA were originally intended to aid investigations into an array of criminal activities, from income tax evasion to money laundering. In recent years, the reports and records prescribed by the BSA have also been utilized as tools for investigating individuals suspected of engaging in illegal drug and terrorist financing activities. Law enforcement agencies have found CTRs to be extremely valuable in tracking the huge amounts of cash generated by individuals and entities for illicit purposes. SARs, used by financial institutions to report identified or suspected illicit or unusual activities, are likewise extremely valuable to law enforcement agencies.

Several acts and regulations expanding and strengthening the scope and enforcement of the BSA, anti-money laundering (AML) measures, and counter-terrorist financing measures have been signed into law and issued, respectively, over the past several decades. Several of these acts include:

- Money Laundering Control Act of 1986,
- Annuzio-Wylie Anti-Money Laundering Act of 1992,
- Money Laundering Suppression Act of 1994, and
- Money Laundering and Financial Crimes Strategy Act of 1998.

Most recently, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (more commonly known as the USA PATRIOT Act) was swiftly enacted by Congress in October 2001, primarily in response to the September 11, 2001 terrorist attacks on the U.S. The USA PATRIOT Act established a host of new measures to prevent, detect, and prosecute those involved in money laundering and terrorist financing.

FINANCIAL CRIMES ENFORCEMENT NETWORK REPORTING AND RECORDKEEPING REQUIREMENTS

Currency Transaction Reports and Exemptions

U.S. financial institutions must file a CTR, Financial Crimes Enforcement Network (FinCEN) Form 104 (formerly known as Internal Revenue Service [IRS] Form 4789), for each currency transaction over $10,000. A currency transaction is any transaction involving the physical transfer of currency from one person to another and covers deposits, withdrawals, exchanges, or transfers of currency or other payments. Currency is defined as currency and coin of the U.S. or any other country as long as it is customarily accepted as money in the country of issue.

Multiple currency transactions shall be treated as a single transaction if the financial institution has knowledge that the transactions are by, or on behalf of, any person and result in either cash in or cash out totaling more than $10,000 during any one business day. Transactions at all branches of a financial institution should be aggregated when determining reportable multiple transactions.

CTR Filing Requirements

Customer and Transaction Information

All CTRs required by 31 CFR 103.22 of the Financial Recordkeeping and Reporting of Currency and Foreign

Transactions regulations must be filed with the IRS. Financial institutions are required to provide all requested information on the CTR, including the following for the person conducting the transaction:

- Name,
- Street address (a post office box number is not acceptable),
- Social security number (SSN) or taxpayer identification number (TIN) (for non-U.S. residents), and
- Date of birth.

The documentation used to verify the identity of the individual conducting the transaction should be specified. Signature cards may be relied upon; however, the specific documentation used to establish the person's identity should be noted. A mere notation that the customer is "known to the financial institution" is insufficient. Additional requested information includes the following:

- Account number,
- Social security number or taxpayer identification number of the person or entity for whose account the transaction is being conducted (should reflect all account holders for joint accounts), and
- Amount and kind of transaction (transactions involving foreign currency should identify the country of origin and report the U.S. dollar equivalent of the foreign currency on the day of the transaction).

The financial institution must provide a contact person, and the CTR must be signed by the preparer and an approving official. Financial institutions can also file amendments on previously filed CTRs by using a new CTR form and checking the box that indicates an amendment.

CTR Filing Deadlines

CTRs filed with the IRS are maintained in the FinCEN database, which is made available to Federal Banking Agencies[1] and law enforcement. Paper forms are to be filed within 15 days following the date of the reportable transaction. If CTRs are filed using magnetic media, pursuant to an agreement between a financial institution and the IRS, a financial institution must file a CTR within 25 calendar days of the date of the reportable transaction. A third option is to file CTRs using the Patriot Act Communication System (PACS), which also allows up to 25 calendar days to file the CTR following the reportable transaction. PACS was launched in October 2002 and permits secure filing of CTRs over the Internet using encryption technology. Financial institutions can access PACS after applying for and receiving a digital certificate.

Examiners reviewing filed CTRs should inquire with financial institution management regarding the manner in which CTRs are filed before evaluating the timeliness of such filings. If for any reason a financial institution should withdraw from the magnetic tape program or the PACS program, or for any other reason file paper CTRs, those CTRs must be filed within the standard 15 day period following the reportable transaction.

Exemptions from CTR Filing Requirements

Certain "persons" who routinely use currency may be eligible for exemption from CTR filings. Exemptions were implemented to reduce the reporting burden and permit more efficient use of the filed records. Financial institutions are not required to exempt customers, but are encouraged to do so. There are two types of exemptions, referred to as "Phase I" and "Phase II" exemptions.

"Phase I" exemptions may be granted for the following "exempt persons":

- A bank[2], to the extent of its domestic operations;
- A Federal, State, or local government agency or department;
- Any entity exercising governmental authority within the U.S. (U.S. includes District of Columbia, Territories, and Indian tribal lands);
- Any listed entity other than a bank whose common stock or analogous equity interests are listed on the New York, American, or NASDAQ stock exchanges (with some exceptions);
- Any U.S. domestic subsidiary (other than a bank) of any "listed entity" that is organized under U.S. law and at least 51 percent of the subsidiary's common stock is owned by the listed entity.

"Phase II" exemptions may be granted for the following:

- A "non-listed business," which includes commercial enterprises that do not have more than 50% of the business gross revenues derived from certain ineligible businesses. Gross revenue has been interpreted to reflect what a business actually earns from an activity conducted by the business, rather than the sales volume of such activity. "Non-listed businesses" must

[1] Federal Banking Agencies consist of the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), and the FDIC.

[2] Bank is defined in The U.S. Department of the Treasury (Treasury) Regulation 31 CFR 103.11.

also be incorporated or organized under U.S. laws and be eligible to do business in the U.S. and may only be exempted to the extent of its domestic operations.

- A "payroll customer," which includes any other person not covered under the "exempt person" definition that operates a firm that regularly withdraws more than $10,000 in order to pay its U.S. employees in currency. "Payroll customers" must also be incorporated and eligible to do business in the U.S. "Payroll customers" may only be exempted on their withdrawals for payroll purposes from existing transaction accounts.

Commercial transaction accounts of sole proprietorships can qualify for "non-listed business" or "payroll customer" exemption.

Exemption of Franchisees

Franchisees of listed corporations (or of their subsidiaries) are not included within the definition of an "exempt person" under "Phase I" unless such franchisees are independently exempt as listed corporations or listed corporation subsidiaries. For example, a local corporation that holds an ABC Corporation franchise is not a "Phase I" "exempt person" simply because ABC Corporation is a listed corporation; however, it is possible that the local corporation may qualify for "Phase II" exemption as a "non-listed business," assuming it meets all other exemption qualification requirements. An ABC Corporation outlet owned by ABC Corporation directly, on the other hand, would be a "Phase I" "exempt person" because ABC Corporation's common stock is listed on the New York Stock Exchange.

Ineligible Businesses

There are several higher-risk businesses that may not be exempted from CTR filings. The nature of these businesses increases the likelihood that they can be used to facilitate money laundering and other illicit activities. Ineligible businesses include:

- Non-bank financial institutions or agents thereof (this definition includes telegraph companies, and money services businesses [currency exchange, check casher, or issuer of monetary instruments in an amount greater than $1,000 to any person in one day]);
- Purchasers or sellers of motor vehicles, vessels, aircraft, farm equipment, or mobile homes;
- Those engaged in the practice of law, medicine, or accountancy;
- Investment advisors or investment bankers;
- Real estate brokerage, closing, or title insurance firms;
- Pawn brokers;
- Businesses that charter ships, aircraft, or buses;
- Auction services;
- Entities involved in gaming of any kind (excluding licensed para mutual betting at race tracks);
- Trade union activities; and
- Any other activities as specified by FinCEN.

Additional Qualification Criteria for Phase II Exemptions

Both "non-listed businesses" and "payroll customers" must meet the following additional criteria to be eligible for "Phase II" exemption:

- The entity has maintained a transaction account with the financial institution for at least twelve consecutive months;
- The entity engages in frequent currency transactions that exceed $10,000 (or in the case of a "payroll customer," regularly makes withdrawals of over $10,000 to pay U.S. employees in currency); and
- The entity is incorporated or organized under the laws of the U.S. or a state, or registered as, and eligible to do business in the U.S. or state.

The financial institution may treat all of the customer's transaction accounts at that financial institution as a single account to qualify for exemption. There may be exceptions to this rule if certain accounts are exclusively used for non-exempt portions of the business. (For example, a small grocery with wire transfer services has a separate account just for its wire business).

Accounts of multiple businesses owned by the same individual(s) are generally not eligible to be treated as a single account. However, it may be necessary to treat such accounts as a single account if the financial institution has evidence that the corporate veil has been pierced. Such evidence may include, but is not limited to:

- Businesses are operated out of the same location and/or utilize the same phone number;
- Businesses are operated by the same daily management and/or board of directors;
- Cash deposits or other banking transactions are completed by the same individual at the same time for the different businesses;
- Funds are frequently intermingled between accounts or there are unexplained transfers from one account to the other; or
- Business activities of the entities cannot be differentiated.

More than one of these factors must typically be present in order to provide sufficient evidence that the corporate veil has been pierced.

Transactions conducted by an "exempt person" as agent or on behalf of another person are not eligible to be exempted based on being transacted by an "exempt person."

Exemption Qualification Documentation Requirements

Decisions to exempt any entity should be based on the financial institution taking reasonable and prudent steps to document the identification of the entity. The specific methodology for performing this assessment is largely at the financial institution's discretion; however, results of the review must be documented. For example, it is acceptable to document that a stock is listed on a stock market by relying on a listing of exchange stock published in a newspaper or by using publicly available information through the Securities and Exchange Commission (SEC). To document the subsidiary of a listed entity, a financial institution may rely on authenticated corporate officer's certificates or annual reports filed with the SEC. Annually, management should also ensure that "Phase I" exempt persons remain eligible for exemption (for example, entities remain listed on National exchanges.)

For "non-listed businesses" and "payroll customers," the financial institution will need to document that the entity meets the qualifying criteria both at the time of the initial exemption and annually thereafter. To perform the annual reviews, the financial institution can verify and update the information that it has in its files to document continued eligibility for exemption. The financial institution must also indicate that it has a system for monitoring the transactions in the account for suspicious activity as it continues to be obligated to file Suspicious Activity Reports on activities of "exempt persons," when appropriate. SARs are discussed in detail within the "Suspicious Activity Reporting" section of this chapter.

Designation of Exempt Person Filings and Renewals

Both "Phase I" and "Phase II" exemptions are filed with FinCEN using Form TD F 90-22.53 - Designation of Exempt Person. This form is available on the Internet at FinCEN's website. The designation must be made separately by each financial institution that treats the person in question as an exempt customer. This designation requirement applies whether or not the designee has previously been treated as exempt from the CTR reporting requirements within 31 CFR 103. Again, the exemption applies only to transactions involving the "exempt person's" own funds. A transaction carried out by an "exempt person" as an agent for another person, who is the beneficial owner of the funds involved in a transaction in currency can not be exempted.

Exemption forms for "Phase I" persons need to be filed only once. A financial institution that wants to exempt another financial institution from which it buys or sells currency must be designated exempt by the close of the 30 day period beginning after the day of the first reportable transaction in currency with the other financial institution. Federal Reserve Banks are excluded from this requirement.

Exemption forms for "Phase II" persons need to be renewed and filed every two years, assuming that the "exempt person" continues to meet all exemption criteria, as verified and documented in the required annual review process discussed above. The filing must be made by March 15th of the second calendar year following the year in which the initial exemption was granted, and by every other March 15th thereafter. When filing a biennial renewal of the exemption for these customers, the financial institution will need to indicate any change in ownership of the business. Initial exemption of a "non-listed business" or "payroll customer" must be made within 30 days after the day of the first reportable transaction in currency that the financial institution wishes to include under the exemption. Form TD F 90-22.53 can be also used to revoke or amend an exemption.

CTR Backfiling

Examiners may determine that a financial institution has failed to file CTRs in accordance with 31 CFR 103, or has improperly exempted customers from CTR filings. In situations where an institution has failed to file a number of CTRs on reportable transactions for any reason, examiners should instruct management to promptly contact the IRS Detroit Computing Center (IRS DCC), Compliance Review Group for instructions and guidance concerning the possible requirement to backfile CTRs for those affected transactions. The IRS DCC will provide an initial determination on whether CTRs should be backfiled in those cases. Cases that involve substantial noncompliance with CTR filing requirements are referred to FinCEN for review. Upon review, FinCEN may correspond directly with the institution to discuss the program deficiencies that resulted in the institution's failure to appropriately file a CTR and the corrective action that management has implemented to prevent further infractions.

When a backfiling request is necessary, examiners should direct financial institutions to write a letter to the IRS at the IRS Detroit Computing Center, Compliance Review Group Attn: Backfiling, P.O. Box 32063, Detroit, Michigan,

48232-0063 that explains why CTRs were not filed. Examiners should also provide the financial institution a copy of the "Check List for CTR Filing Determination" form available on the FDIC's website. The financial institution will need to complete this form and include it with the letter to the IRS.

Once an institution has been instructed to contact IRS DCC for a backfiling determination, examiners should notify both their Regional Special Activities Case Manager (SACM) or other designees and the Special Activities Section (SAS) in Washington, D.C. Specific contacts are listed on the FDIC's Intranet website. Requisite information should be forwarded electronically via e-mail to these contacts.

Currency and Banking Retrieval System

The Currency and Banking Retrieval System (CBRS) is a database of CTRs, SARs, and CTR Exemptions filed with the IRS. It is maintained at the IRS Detroit Computing Center. The SAS, as well as each Region's SACM and other designees, has on-line access to the CBRS. Refer to your Regional Office for a full listing of those individuals with access to the FinCEN database.

Examiners should routinely receive volume and trend information on CTRs and SARs from their Regional SACM or other designees for each examination or visitation prior to the pre-planning process. In addition, the database information may be used to verify CTR, SAR and/or CTR Exemption filings. Detailed FinCEN database information may be used for expanded BSA reviews or in any unusual circumstances where examiners suspect certain forms have not been filed by the financial institution, or where suspicious activity by individuals has been detected.

Examiners should provide all of the following items they have available for each search request:

- The name of the subject of the search (financial institution and/or individual/entity);
- The subject's nine-digit TIN/SSN (in Part III of the CTR form if seeking information on the financial institution and/or Part I of the CTR form if seeking information on the individual/entity); and
- The date range for which the information is requested.

When requesting a download or listing of CTR and SAR information, examiners should take into consideration the volume of CTRs and SARs filed by the financial institution under examination when determining the date range requested. Except under unusual circumstances, the date range for full listings should be no greater than one year. For financial institutions with a large volume of records, three months or less may be more appropriate.

Since variations in spellings of an individual's name are possible, accuracy of the TIN/SSN is essential in ensuring accuracy of the information received from the FinCEN database. To this end, examiners should also identify any situations where a financial institution is using more than one tax identification number to file their CTRs and/or SARs. To reduce the possibility of error in communicating CTR and SAR information/verification requests, examiners are requested to e-mail or fax the request to their Regional SACM or other designee.

Other FinCEN Reports

Report of International Transportation of Currency or Monetary Instruments

Treasury regulation 31 CFR 103.23 requires the filing of FinCEN Form 105, formerly Form 4790, to comply with other Treasury regulations and U.S. Customs disclosure requirements involving physical transport, mailing or shipping of currency or monetary instruments greater than $10,000 at one time out of or into the U.S. The report is to be completed by or on behalf of the person requesting the transfer of the funds and filed within 15 days. However, financial institutions are not required to report these items if they are mailed or shipped through the postal service or by common carrier. Also excluded from reporting are those items that are shipped to or received from the account of an established customer who maintains a deposit relationship with the bank, provided the item amounts are commensurate with the customary conduct of business of the customer concerned.

In situations where the quantity, dollar volume, and frequency of the currency and/or monetary instruments are not commensurate with the customary conduct of the customer, financial institution management will need to conduct further documented research on the customer's transactions and determine whether a SAR should be filed with FinCEN. Please refer to the discussion on "Customer Due Diligence" and "Suspicious Activity Reporting" within this chapter for detailed guidance.

Reports of Foreign Bank Accounts

Within 31 CFR 103.24, the Treasury requires each person who has a financial interest in or signature authority, or other authority over any financial accounts, including bank, securities, or other types of financial accounts, maintained in a foreign country to report those relationships to the IRS annually if the aggregate value of the accounts exceeds

$10,000 at any point during the calendar year. The report should be filed by June 30 of the succeeding calendar year, using Form TD F 90-22.1 available on the FinCEN website. By definition, a foreign country includes all locations outside the United States, Guam, Puerto Rico, the Virgin Islands, the Northern Mariana Islands, American Samoa, and Trust Territory of the Pacific Islands. U.S. military banking facilities are excluded. Foreign assets including securities issued by foreign corporations that are held directly by a U.S. person, or through an account maintained with a U.S. office of a bank or other institution are not subject to the BSA foreign account reporting requirements. The bank is also not required to report international interbank transfer accounts ("nostro accounts") held by domestic banks. Also excluded are accounts held in a foreign financial institution in the name of, or on behalf of, a particular customer of the financial institution, or that are used solely for the transactions of a particular customer. Finally, an officer or employee of a federally-insured depository institution branch, or agency office within the U.S. of a foreign bank that is subject to the supervision of a Federal bank regulatory agency need not report that he or she has signature or other authority over a foreign bank, securities or other financial account maintained by such entities unless he or she has a personal financial interest in the account.

FinCEN Recordkeeping Requirements

Required Records for Sales of Monetary Instruments for Cash

Treasury regulation 31 CFR 103.29 prohibits financial institutions from issuing or selling monetary instruments purchased with cash in amounts of $3,000 to $10,000, inclusive, unless it obtains and records certain identifying information on the purchaser and specific transaction information. Monetary instruments include bank checks, bank drafts, cashier's checks, money orders, and traveler's checks. Furthermore, the identifying information of all purchasers must be verified. The following information must be obtained from a purchaser who has a deposit account at the financial institution:

- Purchaser's name;
- Date of purchase;
- Type(s) of instrument(s) purchased;
- Serial number(s) of each of the instrument(s) purchased; and
- Amounts in dollars of each of the instrument(s) purchased.

If the purchaser does not have a deposit account at the financial institution, the following additional information must be obtained:

- Address of the purchaser (a post office box number is not acceptable);
- Social security number (or alien identification number) of the purchaser;
- Date of birth of the purchaser; and
- Verification of the name and address with an acceptable document (i.e. driver's license).

The regulation requires that multiple purchases during one business day be aggregated and treated as one purchase. Purchases of different types of instruments at the same time are treated as one purchase and the amounts should be aggregated to determine if the total is $3,000 or more. In addition, the financial institution should have procedures in place to identify multiple purchases of monetary instruments during one business day, and to aggregate this information from all of the bank branch offices.

If a customer first deposits the cash in a bank account, then purchases a monetary instrument(s), the transaction is still subject to this regulatory requirement. The financial institution is not required to maintain a log for these transactions, but should have procedures in place to recreate the transactions.

The information required to be obtained under 31 CFR 103.29 must be retained for a period of five years.

Funds Transfer and Travel Rule Requirements

Treasury regulation 31 CFR Section 103.33 prescribes information that must be obtained for funds transfers in the amount of $3,000 or more. There is a detailed discussion of the recordkeeping requirements and risks associated with wire transfers within the "Banking Services and Activities with Greater Potential for Money Laundering and Terrorist Financing Vulnerabilities" discussion within this chapter.

Records to be Made and Retained by Financial Institutions

Treasury regulation 31 CFR 103.33 states that each financial institution must retain either the original or a microfilm or other copy/reproduction of each of the following:

- A record of each extension of credit in an amount in excess of $10,000, except an extension of credit secured by an interest in real property. The record

must contain the name and address of the borrower, the loan amount, the nature or purpose of the loan, and the date the loan was made. The stated purpose can be very general such as a passbook loan, personal loan, or business loan. However, financial institutions should be encouraged to be as specific as possible when stating the loan purpose. Additionally, the purpose of a renewal, refinancing, or consolidation is not required as long as the original purpose has not changed and the original statement of purpose is retained for a period of five years after the renewal, refinancing or consolidation has been paid out.

- A record of each advice, request, or instruction received or given regarding any transaction resulting in the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit, of more than $10,000 to or from any person, account, or place outside the U.S. This requirement also applies to transactions later canceled if such a record is normally made.

Required Records for Deposit Accounts

Treasury regulation 31 CFR 103.34 requires banking institutions to obtain and retain a social security number or taxpayer identification number for each deposit account opened after June 30, 1972, and before October 1, 2003. The same information must be obtained for each certificate of deposit sold or redeemed after May 31, 1978, and before October 1, 2003. The banking institution must make a reasonable effort to obtain the identification number within 30 days after opening the account, but will not be held in violation of the regulation if it maintains a list of the names, addresses, and account numbers of those customers from whom it has been unable to secure an identification number. Where a person is a nonresident alien, the banking institution shall also record the person's passport number or a description of some other government document used to verify his/her identity.

Furthermore, 31 CFR 103.34 generally requires banks to maintain records of items needed to reconstruct transaction accounts and other receipts or remittances of funds through a bank. Specific details of these requirements are in the regulation.

Record Retention Period and Nature of Records

All records required by the regulation shall be retained for five years. Records may be kept in paper or electronic form. Microfilm, microfiche or other commonly accepted forms of records are acceptable as long as they are accessible within a reasonable period of time. The record should be able to show both the front and back of each document. If no record is made in the ordinary course of business of any transaction with respect to which records are required to be retained, then such a record shall be prepared in writing by the financial institution.

CUSTOMER IDENTIFICATION PROGRAM

Section 326 of the USA PATRIOT Act, which is implemented by 31 CFR 103.121, requires banks, savings associations, credit unions, and certain non-federally regulated banks to implement a written Customer Identification Program (CIP) appropriate for its size and type of business. For Section 326, the definition of **financial institution** encompasses a variety of entities, including **banks**, agencies and branches of foreign banks in the U.S., thrifts, credit unions, private banks, trust companies, investment companies, brokers and dealers in securities, futures commission merchants, insurance companies, travel agents, pawnbrokers, dealers in precious metals, check cashers, casinos, and telegraph companies, among many others identified at 31 USC 5312(a)(2) and (c)(1)(A). As of October 1, 2003, all institutions and their operating subsidiaries must have in place a CIP pursuant to Treasury regulation 31 CFR 103.121.

The CIP rules do not apply to a **financial institution**'s foreign subsidiaries. However, **financial institutions** are encouraged to implement an effective CIP throughout their operations, including their foreign offices, except to the extent that the requirements of the rule would conflict with local law.

Applicability of CIP Regulation

The CIP rules apply to **banks**, as defined in 31 CFR 103.11 that are subject to regulation by a Federal Banking Agency and to any non-Federally-insured credit union, private bank or trust company that does not have a Federal functional regulator. Entities that are regulated by the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) are subject to separate rulemakings. It is intended that the effect of all of these rules be uniform throughout the financial services industry.

CIP Requirements

31 CFR 103.121 requires a **bank** to develop and implement a written, board-approved CIP, appropriate for its size and type of business that includes, at a minimum, procedures for:

- Verifying a customer's true identity to the extent reasonable and practicable and defining the methodologies to be used in the verification process;
- Collecting specific identifying information from each customer when opening an account;
- Responding to circumstances and defining actions to be taken when a customer's true identity cannot be appropriately verified with "reasonable belief;"
- Maintaining appropriate records during the collection and verification of a customer's identity;
- Verifying a customer's name against specified terrorist lists; and
- Providing customers with adequate notice that the **bank** is requesting identification to verify their identities.

While not required, a **bank** may also include procedures for:

- Specifying when it will rely on another **financial institution** (including an affiliate) to perform some or all of the elements of the CIP.

Additionally, 31 CFR 103.121 provides that a **bank** with a Federal functional regulator must formally incorporate its CIP into its written board-approved anti-money laundering program. The FDIC expanded Section 326.8 of its Rules and Regulations to require each **FDIC-supervised institution** to implement a CIP that complies with 31 CFR 103.121 and incorporate such CIP into a bank's written board-approved BSA compliance program (with evidence of such approval noted in the board meeting minutes). Consequently, a **bank** must specifically provide:

- Internal policies, procedures, and controls;
- Designation of a compliance officer;
- Ongoing employee training programs; and
- An independent audit function to test program.

The slight difference in wording between the Treasury's and FDIC's regulations regarding incorporation of a bank's CIP within its anti-money laundering program and BSA compliance program, respectively, was not intended to create duplicative requirements. Therefore, an FDIC-regulated **bank** must include its CIP within its anti-money laundering program and the latter included under the "umbrella" of its overall BSA/AML program.

CIP Definitions

As discussed above, both Section 326 of the USA PATRIOT Act and 31 CFR 103.121 specifically define the terms **financial institution** and **bank**. Similarly, specific definitions are provided for the terms **person**, **customer**, and **account**. Both bank management and examiners must properly understand these terms in order to effectively implement and assess compliance with CIP regulations, respectively.

Person

A **person** is generally an individual or other legal entity (such as registered corporations, partnerships, and trusts).

Customer

A **customer** is generally defined as any of the following:

- A **person** that opens a new **account** (**account** is defined further within the discussion of CIP definitions);
- An individual acting with "power of attorney"(POA)[3] who opens a new **account** to be owned by or for the benefit of a **person** lacking legal capacity, such as a minor;
- An individual who opens an **account** for an entity that is not a legal person, such as a civic club or sports boosters;
- An individual added to an existing **account** or one who assumes an existing debt at the **bank;** or
- A deposit broker who brings new customers to the bank (as discussed in detail later within this section).

The definition of **customer** excludes:

- A financial institution regulated by a Federal Banking Agency or a bank regulated by a State bank regulator[4];
- A department or agency of the U.S. Government, of any state, or of any political subdivision of any state;
- Any entity established under the laws of the U.S., of any state, or of any political subdivision of any state, or under an interstate compact between two or more states, that exercises governmental authority on behalf of the U.S. or any such state or political subdivision (U.S. includes District of Columbia and Indian tribal lands and governments); or

[3] If a POA individual opens an account for another individual with legal capacity or for a legal entity, then the **customer** is still the account holder. In this case, the POA is an agent acting on behalf of the **person** that opens the account and the CIP must still cover the account holder (unless the person lacks legal capacity).

[4] The IRS is not a Federal functional regulator. Consequently, money service businesses, such as check cashers and wire transmitters that are regulated by the IRS are not exempted from the definition of customer for CIP purposes.

- Any entity, other than a bank, whose common stock or analogous equity interests are listed on the New York or American Stock Exchanges or whose common stock or analogous equity interests have been designated as a NASDAQ National Market Security listed on the NASDAQ Stock Market (except stock or interests listed under the separate "NASDAQ Small-Cap Issues" heading). A listed company is exempted from the definition of **customer** only for its domestic operations.

The definition of **customer** also excludes a **person** who has an existing account with a bank, provided that the bank has a "reasonable belief" that it knows the true identity of the **person**. So, if the **person** were to open an additional account, or renew or roll over an existing account, CIP procedures would not be required. A bank can demonstrate that is has a "reasonable belief" that it knows the identity of an existing customer by:

- Demonstrating that it had similar procedures in place to verify the identity of **persons** prior to the effective date of the CIP rule. (An "affidavit of identity" by a bank officer is not acceptable for demonstrating "reasonable belief.")
- Providing a history of **account** statements sent to the **person.**
- **Maintaining account** information sent to the IRS regarding the **person's accounts** accompanied by IRS replies that contain no negative comments.
- Providing evidence of loans made and repaid, or other services performed for the **person** over a period of time.

These actions may not be sufficient for existing account holders deemed to be high risk. For example, in the situation of an import/export business where the identifying information on file only includes a number from a passport marked as a duplicate with no additional business information on file, the bank should follow all of the CIP requirements provided in 31 CFR 103.121 since it does not have sufficient information to show a "reasonable belief" of the true identity of the existing account holder.

Account

An **account** is defined as a formal, ongoing banking relationship established to provide or engage in services, dealings, or other financial transactions including:

- Deposit accounts;
- Transaction or asset accounts ;
- Credit accounts, or any other extension of credit;
- Safety deposit box or other safekeeping services;
- Cash management, custodian, and trust services; or
- Any other type of formal, ongoing banking relationship.

The definition of **account** specifically excludes the following:

- Product or service where a formal banking relationship is NOT established with a **person**. Thus CIP is not intended for infrequent transactions and activities (already covered under other recordkeeping requirements within 31 CFR 103) such as:
  - Check cashing,
  - Wire transfers,
  - Sales of checks,
  - Sales of money orders;
- Accounts acquired through an acquisition, merger, purchase of assets, or assumption of liabilities (as these "new" accounts were not initiated by customers);[5] and
- Accounts opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974 (ERISA).

Furthermore, the CIP requirements do not apply to a **person** who does not receive banking services, such as a **person** who applies for a loan but has his/her application denied. The **account** in this circumstance is only opened when the bank enters into an enforceable agreement to provide a loan to the **person** (who therefore also simultaneously becomes a **customer**).

Collecting Required Customer Identifying Information

The CIP must contain account opening procedures that specify the identifying information obtained from each customer prior to opening the account. The minimum required information includes:

- Name.
- Date of birth, for an individual.

[5] Accounts acquired by purchase of assets from a third party are excluded from the CIP regulations, provided the purchase was not made under an agency in place or exclusive sale arrangement, where the bank has final approval of the credit. If under an agency arrangement, the bank may rely on the agent third party to perform the bank's CIP, but it must ensure that the agent is performing the bank's CIP program. For example, a pool of auto loans purchased from an auto dealer after the loans have already been made would not be subject to the CIP regulations. However, if the bank is directly extending credit to the borrower and is using the car dealer as its agent to gather information, then the bank must ensure that the dealer is performing the bank's CIP.

- Physical address[6], which shall be:
  - for an individual, a residential or business street address (An individual who does not have a physical address may provide an Army Post Office [APO] or a Fleet Post Office [FPO] box number, or the residential or business street address of next of kin or of another contact individual. Using the box number on a rural route is acceptable description of the physical location requirement.)
  - for a person other than an individual (such as corporations, partnerships, and trusts), a principal place of business, local office, or other physical location.
- Identification number including a SSN, TIN, Individual Tax Identification Number (ITIN), or Employer Identification Number (EIN).

For non-U.S. persons, the bank must obtain one or more of the following identification numbers:

- Customer's TIN,
- Passport number and country of issuance,
- Alien identification card number, and
- Number and country of issuance of any other (foreign) government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

When opening an account for a foreign business or enterprise that does not have an identification number, the bank must request alternative government-issued documentation certifying the existence of the business or enterprise.

Exceptions to Required Customer Identifying Information

The bank may develop, include, and follow CIP procedures for a customer who at the time of account opening, has applied for, but has not yet received, a TIN. However, the CIP must include procedures to confirm that the application was filed before the customer opens the account and procedures to obtain the TIN within a reasonable period of time after the account is opened.

There is also an exception to the requirement that a bank obtain the above-listed identifying information from the customer prior to opening an account in the case of credit card accounts. A bank may obtain identifying information (such as TIN) from a third-party source prior to extending credit to the customer.

Verifying Customer Identity Information

The CIP should rely on a **risk-focused** approach when developing procedures for verifying the identity of each customer to the extent reasonable and practicable. A bank need not establish the accuracy of every element of identifying information obtained in the account opening process, but must do so for enough information to form a "reasonable belief" that it knows the true identity of each customer. At a minimum, the **risk-focused** procedures must be based on, but not limited to, the following factors:

- Risks presented by the various types of accounts offered by the bank;
- Various methods of opening accounts provided by the bank;
- Various sources and types of identifying information available; and
- The bank's size, location, and customer base.

Furthermore, a bank's CIP procedures must describe when the bank will use **documentary verification methods**, **non-documentary verification methods**, or a **combination of both methods**.

Documentary Verification

The CIP must contain procedures that set forth the specific documents that the bank will use. For an individual, the documents may include:

- Unexpired government-issued identification evidencing nationality or residence, and bearing a photograph or similar safeguard, such as a driver's license or passport.

For a person other than an individual (such as a corporation, partnership, or trust), the documents may include:

- Documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, trust instrument, a certificate of good standing, or a business resolution.

Non-Documentary Verification

[6] The bank MUST obtain a physical address: a P.O. Box alone is NOT acceptable. Collection of a P.O. Box address and/or alternate mailing address is optional and potentially very useful as part of the bank's Customer Due Diligence (CDD) program.

Banks are not required to use non-documentary methods to verify a customer's identity. However, if a bank chooses to do so, a description of the approved non-documentary methods must be incorporated in the CIP. Such methods may include:

- Contacting the customer,
- Checking references with other financial institution,
- Obtaining a financial statement, and
- Independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from consumer reporting agencies (for example, Experian, Equifax, TransUnion, Chexsystems), public databases (for example, Lexis, Dunn and Bradstreet), or other sources (for example, utility bills, phone books, voter registration bills).

The bank's non-documentary procedures must address situations such as:

- The inability of a customer to present an unexpired government-issued identification document that bears a photograph or similar safeguard;
- Unfamiliarity on the bank's part with the documents presented;
- Accounts opened without obtaining documents;
- Accounts opened without the customer appearing in person at the bank (for example, accounts opened through the mail or over the Internet); and
- Circumstances increasing the risk that the bank will be unable to verify the true identity of a customer through documents.

Many of the risks presented by these situations can be mitigated. A bank that accepts items that are considered secondary forms of identification, such as utility bills and college ID cards, is encouraged to review more than a single document to ensure that it has formed a "reasonable belief" of the customer's true identity. Furthermore, in instances when an account is opened over the Internet, a bank may be able to obtain an electronic credential, such as a digital certificate, as one of the methods it uses to verify a customer's identity.

Additional Verification Procedures for Customers (Non-Individuals)

The CIP must address situations where, based on a risk assessment of a new account that is opened by a customer that is not an individual, the bank will obtain information about individuals with authority or control over such accounts, in order to verify the customer's identity. These individuals could include such parties as signatories, beneficiaries, principals, and guarantors. As previously stated, a risk-focused approach should be applied to verify customer accounts. For example, in the case of a well-known firm, company information and verification could be sufficient without obtaining and verifying identity information for all signatories. However, in the case of a relatively new or unknown firm, it would be in the bank's best interest to obtain and verify a greater volume of information on signatories and other individuals with control or authority over the firm's account.

Inability to Verify Customer Identity Information

The CIP must include procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe, at a minimum, the following:

- Circumstances when the bank should not open an account;
- The terms or limits under which a customer may use an account while the bank attempts to verify the customer's identity (for example, minimal or no funding on credit cards, holds on deposits, limits on wire transfers);
- Situations when an account should be closed after attempts to verify a customer's identity have failed; and
- Conditions for filing a SAR in accordance with applicable laws and regulations.

Recordkeeping Requirements

The bank's CIP must include recordkeeping procedures for:

- Any document that was relied upon to verify identity noting the type of document, the identification number, the place of issuance, and, if any, the dates of issuance and expiration;
- The method and results of any measures undertaken to perform non-documentary verification procedures; and
- The results of any substantive discrepancy discovered when verifying the identifying information obtained.

Banks are not required to make and retain photocopies of any documents used in the verification process. However, if a bank does choose to do so, it must ensure that these photocopies are physically secured to adequately protect against possible identity theft. In addition, such photocopies should not be maintained with files and documentation relating to credit decisions in order to avoid any potential problems with consumer compliance regulations.

Required Retention Period

All required customer identifying information obtained in the account opening process must be retained for five years after the account is closed, or in the case of credit card accounts, five years after the account is closed or becomes dormant. The other "required records" (descriptions of documentary and non-documentary verification procedures and any descriptions of substantive discrepancy resolution) must be retained for five years after the record is made. If several accounts are opened at a bank for a customer simultaneously, all of the required customer identifying information obtained in the account opening process must be retained for five years after the last account is closed, or in the case of credit card accounts, five years after the last account is closed or becomes dormant. As in the case of a single account, all other "required records" must be kept for five years after the records are made.

Comparison with Government Lists of Known or Suspected Terrorists

The CIP must include procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by the Treasury in consultation with the other Federal functional regulators.

The comparison procedures must be performed and a determination made within a reasonable period of time after the account is opened, or earlier, as required and directed by the issuing agency. Since the USA PATRIOT Act Section 314(a) Requests, discussed in detail under the heading entitled "Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activities," are one-time only searches, they are not applicable to the CIP.

Adequate Customer Notice

The CIP must include procedures for providing customers with adequate notice that the bank is requesting information to verify their identities. This notice must indicate that the institution is collecting, verifying, and recording the customer identity information as outlined in the CIP regulations. Furthermore, the customer notice must be provided prior to account opening, with the general belief that it will be clearly read and understood. This notice may be posted on a lobby sign, included on the bank's website, provided orally, or disclosed in writing (for example, account application or separate disclosure form). The regulation provides sample language that may be used for providing adequate customer notice. In the case of joint accounts, the notice must be provided to all joint owners; however, this may be accomplished by providing notice to one owner for delivery to the other owners.

Reliance on Another Financial Institution's CIP

A bank may develop and implement procedures for relying on another financial institution for the performance of CIP procedures, yet the CIPs at both entities do not have to be identical. The reliance can be used with respect to any bank customer that is opening or has opened an account or similar formal relationship with the relied-upon financial institution. Additionally, the following requirements must be met:

- Reliance is reasonable, under the circumstances;
- The relied-upon financial institution (including an affiliate) is subject to the same anti-money laundering program requirements as a bank, and is regulated by a Federal functional regulator (as previously defined); and
- A signed contract exists between the two entities that requires the relied-upon financial institution to certify annually that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) the specified requirements of the bank's CIP.

To strengthen such an arrangement, the signed contract should include a provision permitting the bank to have access to the relied-upon institution's annual independent review of its CIP.

Deposit Broker Activity

The use of deposit brokers is a common funding mechanism for many financial institutions. This activity is considered higher risk because each deposit broker operates under its own operating guidelines to bring customers to a bank. Consequently, the deposit broker may not be performing sufficient Customer Due Diligence (CDD), Office of Foreign Assets Control (OFAC) screening (refer to the detailed OFAC discussion provided elsewhere within this chapter), or CIP procedures. The bank accepting brokered deposits relies upon the deposit broker to have sufficiently performed all required account opening procedures and to have followed all BSA and AML program requirements.

Deposit Broker is Customer

Regulations contained in 31 CFR 103.121 specifically defines the term customer as a person (individual, registered corporation, partnership, or trust). Therefore, according to this definition, if a deposit broker opens an

account(s), the customer is the deposit broker NOT the deposit broker's clients.

Deposit Broker's CIP

Deposit brokers must follow their own CIP requirements for their customers. If the deposit broker is registered with the SEC, then it is required to follow the same general CIP requirements as banking institutions and is periodically examined by the SEC for compliance. However, if the deposit broker does not come under the SEC's jurisdiction, they may not be following any due diligence laws or guidelines.

As such, banks accepting deposit broker accounts should establish policies and procedures regarding the brokered deposits. Policies should establish minimum due diligence procedures for all deposit brokers providing business to the bank. The level of due diligence a bank performs should be commensurate with its knowledge of the deposit broker and the broker's known business practices.

Banks should conduct **enhanced** due diligence on unknown and/or unregulated deposit brokers. For protection, the bank should determine that the:

- Deposit broker is legitimate;
- Deposit broker is following appropriate guidance and/or regulations;
- Deposit broker's policies and procedures are sufficient;
- Deposit broker has adequate CIP verification procedures;
- Deposit broker screens clients for OFAC matches;
- BSA/OFAC audit reviews are adequate and show compliance with requirements; and
- Bank management is aware of the deposit broker's anticipated volume and transaction type.

Special care should be taken with deposit brokers who:

- Are previously unknown to the bank;
- Conduct business or obtain deposits primarily in another country;
- Use unknown or hard-to-contact businesses and banks for references;
- Provide other services which may be suspect, such as creating shell corporations for foreign clients;
- Advertise their own deposit rates, which vary widely from those offered by banking institutions; and
- Refuse to provide requested due diligence information or use methods to get deposits placed before providing information.

Banks doing business with deposit brokers are encouraged to include contractual requirements for the deposit broker to establish and conduct procedures for minimum CIP, CDD, and OFAC screening.

Finally, the bank should monitor brokered deposit activity for unusual activity, including cash transactions, structuring, and funds transfer activity. Monitoring procedures should identify any "red flags" suggesting that the deposit broker's customers (the ultimate customers) are trying to conceal their true identities and/or their source of wealth and funds.

Additional Guidance on CIP Regulations

Comprehensive guidance regarding CIP regulations and related examination procedures can be found within FDIC FIL 90-2004, Guidance on Customer Identification Programs. On January 9, 2004, the Treasury, FinCEN, and the Federal Financial Institutions Examination Council (FFIEC) regulatory agencies issued joint interpretive guidance addressing frequently asked questions (FAQs) relating to CIP requirements in FIL-4-2004. Additional information regarding CIP can be found on the FinCEN website.

SPECIAL INFORMATION SHARING PROCEDURES TO DETER MONEY LAUNDERING AND TERRORIST ACTIVITIES

Section 314 of the USA PATRIOT Act covers special information sharing procedures to deter money laundering and terrorist activities. These are the only two categories that apply under Section 314 information sharing; no information concerning other suspicious or criminal activities can be shared under the provisions of Section 314 of the USA PATRIOT Act. Final regulations of the following two rules issued on March 4, 2002, became effective on September 26, 2002:

- Section 314(a), codified into 31 CFR 103.100, requires **mandatory** information sharing between the U.S. Government (FinCEN, Federal law enforcement agencies, and Federal Banking Agencies) and financial institutions.
- Section 314(b), codified into 31 CFR 103.110, encourages **voluntary** information sharing between financial institutions and/or associations of financial institutions.

Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions

A Federal law enforcement agency investigating terrorist activity or money laundering may request that FinCEN solicit, on its behalf, certain information from a financial institution or a group of financial institutions on certain individuals or entities. The law enforcement agency must provide a written certification to FinCEN attesting that credible evidence of money laundering or terrorist activity exists. It must also provide specific identifiers such as date of birth, address, and social security number of the individual(s) under investigation that would permit a financial institution to differentiate among customers with common or similar names.

Section 314(a) Requests

Upon receiving an adequate written certification from a law enforcement agency, FinCEN may require financial institutions to perform a search of their records to determine whether they maintain or have maintained accounts for, or have engaged in transactions with, any specified individual, entity, or organization. This process involves providing a Section 314(a) Request to the financial institutions. Such lists are issued to financial institutions every two weeks by FinCEN.

Each Section 314(a) request has a unique tracking number. The general instructions for a Section 314(a) Request require financial institutions to complete a **one-time** search of their records and respond to FinCEN, if necessary, within **two weeks**. However, individual requests can have different deadline dates. Any specific guidelines on the request supercede the general guidelines.

Designated Point-of-Contact for Section 314(a) Requests

All financial institutions shall designate at least one point-of-contact for Section 314(a) requests and similar information requests from FinCEN. FDIC-supervised financial institutions must promptly notify the FDIC of any changes to the point-of-contact, which is reported on each Call Report.

Financial Institution Records Required to be Searched

The records that must be searched for a Section 314(a) Request are specified in the request itself. Using the identifying information contained in the 314(a) request, financial institutions are required to conduct a **one-time** search of the following records, **whether or not they are kept electronically (subject to the limitations below)**:

- Deposit account records;
- Funds transfer records;
- Sales of monetary instruments (purchaser only);
- Loan records;
- Trust department records;
- Securities records (purchases, sales, safekeeping, etc.);
- Commodities, options, and derivatives; and
- Safe deposit box records (but only if searchable electronically).

According to the general instructions to Section 314(a), financial institutions are NOT required to research the following documents for matches:

- Checks processed through an account for a payee,
- Monetary instruments for a payee,
- Signature cards, and
- CTRs and SARs previously filed.

The general guidelines specify that the record search need only encompass current accounts and accounts maintained by a named subject during the preceding twelve (12) months, and transactions not linked to an account conducted by a named subject during the preceding six (6) months. Any record described above that is not maintained in electronic form need only be searched if it is required to be kept under federal law or regulation.

Again, if the specific guidelines or the timeframe of records to be searched on a Section 314(a) Request differ from the general guidelines, they should be followed to the extent possible. For example, if a particular Section 314(a) Request asks financial institutions to search their records back eight years, the financial institutions should honor such requests to the extent possible, even though BSA recordkeeping requirements generally do not require records to be retained beyond five years.

Reporting of "Matches"

Financial institutions typically have a two-week window to complete the one-time search and respond, if necessary to FinCEN. If a financial institution identifies an account or transaction by or on behalf of an individual appearing on a Section 314(a) Request, it must report back to FinCEN that it has a "positive match," unless directed otherwise. When reporting this information to FinCEN, no additional details, unless otherwise instructed, should be provided other than the fact that a "positive match" has been identified. In situations where a financial institution is unsure of a match, it may contact the law enforcement agency specified in the Section 314(a) Request. Negative responses to Section 314(a) Requests are not required; the financial institution

does not need to respond to FinCEN on a Section 314(a) Request if there are no matches to the institution's records. Financial institutions are to be reminded that unless a name is repeated on a subsequent Section 314(a) Request, that name does not need to be searched again.

The financial institution **must not** notify a customer that he/she has been included on a Section 314(a) Request. Furthermore, the financial institution must not tell the customer that he/she is under investigation or that he/she is suspected of criminal activity.

Restrictions on Use of Section 314(a) Requests

A financial institution may only use the information identified in the records search to report "positive matches" to FinCEN and to file, when appropriate, SARs. If the financial institution has a "positive match," account activity with that customer or entity is not prohibited; it is acceptable for the financial institution to open new accounts or maintain current accounts with Section 314(a) Request subjects; the closing of accounts is not required. However, the Section 314(a) Requests may be useful as a determining factor for such decisions if the financial institution so chooses. Unlike OFAC lists, Section 314(a) Requests are not permanent "watch lists." In fact, Section 314(a) Requests are not updated or corrected if an investigation is dropped, a prosecution is declined, or a subject is exonerated, as they are point-in-time inquiries. Furthermore, the names provided on Section 314(a) Requests do not necessarily correspond to convicted or indicted persons; rather, a Section 314(a) Request subject need only be "reasonably suspected," based on credible evidence of engaging in terrorist acts or money laundering to appear on the list.

SAR Filings

If a financial institution has a positive match within its records, it is not required to automatically file a SAR on the identified subject. In other words, the subject's presence on the Section 314(a) Request should not be the sole factor in determining whether to file a SAR. However, prudent BSA compliance practices should ensure that the subject's accounts and transactions be scrutinized for suspicious or unusual activity. If, after such a review is performed, the financial institution's management has determined that the subject's activity is suspicious, unusual, or inconsistent with the customer's profile, then the timely filing of an SAR would be warranted.

Confidentiality of Section 314(a) Requests

Financial institutions must protect the security of the Section 314(a) Requests, as they are confidential. As stated previously, a financial institution must not tip off a customer that he/she is the subject of a Section 314(a) Request. Similarly, a financial institution cannot disclose to any person or entity, other than to FinCEN, its primary Federal functional regulator, or the Federal law enforcement agency on whose behalf FinCEN is requesting information, the fact that FinCEN has requested or obtained information from a Section 314(a) Request.

FinCEN has stated that an affiliated group of financial institutions may establish one point-of-contact to distribute the Section 314(a) Requests for the purpose of responding to requests. However, the Section 314(a) Requests should not be shared with foreign affiliates or foreign subsidiaries (unless the request specifically states otherwise), and the lists cannot be shared with affiliates or subsidiaries of bank holding companies that are not financial institutions.

Notwithstanding the above restrictions, a financial institution is authorized to share information concerning an individual, entity, or organization named in a Section 314(a) Request from FinCEN with other financial institutions and/or financial institution associations in accordance with the certification and procedural requirements of Section 314(b) of the USA PATRIOT Act discussed below. However, such sharing shall not disclose the fact that FinCEN has requested information on the subjects or the fact that they were included within a Section 314(a) Request.

Internal Financial Institution Measures for Protecting Section 314(a) Requests

In order to protect the confidentiality of the Section 314(a) Requests, these documents should only be provided to financial institution personnel who need the information to conduct the search and should not be left in an unprotected or unsecured area. A financial institution may provide the Section 314(a) Request to third-party information technology service providers or vendors to perform/facilitate the record searches so long as it takes the necessary steps to ensure that the third party appropriately safeguards the information. It is important to remember that the financial institution remains ultimately responsible for the performance of the required searches and to protect the security and confidentiality of the Section 314(a) Requests.

Each financial institution must maintain adequate procedures to protect the security and confidentiality of requests from FinCEN. The procedures to ensure confidentiality will be considered adequate if the financial

institution applies procedures similar to those it has established to comply with Section 501 of the Gramm-Leach-Bliley Act (15 USC 6801) with regard to the protection of its customers' non-public personal information.

Financial institutions should keep a log of all Section 314(a) Requests received and any "positive matches" identified and reported to FinCEN. Additionally, documentation that all required searches were performed is essential. The financial institution should not need to keep copies of the Section 314(a) Requests, noting the unique tracking number will suffice. Some financial institutions may choose to destroy the Section 314(a) Requests after searches are performed. If a financial institution chooses to keep the Section 314(a) Requests for audit/internal review purposes, it should not be criticized for doing so, as long as it appropriately secures them and protects their confidentiality.

FinCEN has provided financial institutions with general instructions, FAQs, and additional guidance relating to the Section 314(a) Request process. These documents are revised periodically and may be found on FinCEN's Web site.

Section 314(b) - Voluntary Information Sharing

Section 314(b) of the USA PATRIOT Act encourages financial institutions and financial institution associations (for example, bank trade groups and associations) to share information on individuals, entities, organizations, and countries suspected of engaging in possible terrorist activity or money laundering. Section 314(b) limits the definition of "financial institutions" used within Section 314(a) of USA PATRIOT Act to include only those institutions that are required to establish and maintain an anti-money laundering program; this definition includes, but is not limited to, banking entities regulated by the Federal Banking Agencies. The definition specifically excludes any institution or class of institutions that FinCEN has designated as ineligible to share information. Section 314(b) also describes the safe harbor from civil liability that is provided to financial institutions that appropriately share information within the limitations and requirements specified in the regulation.

Restrictions on Use of Shared Information

Information shared on a subject from a financial institution or financial institution association pursuant to Section 314(b) cannot be used for any purpose other than the following:

- Identifying and, where appropriate, reporting on money laundering or terrorist activities;
- Determining whether to establish or maintain an account, or to engage in a transaction; or
- Assisting in the purposes of complying with this section.

Annual Certification Requirements

In order to avail itself to the statutory safe harbor protection, a financial institution or financial institution association must annually certify with FinCEN stating its intent to engage in information sharing with other similarly-certified entities. It must further state that it has established and will maintain adequate procedures to protect the security and confidentiality of the information, as if the information were included in one of its own SAR filings. The annual certification process involves completing and submitting a "Notice for Purposes of Subsection 314(b) of the USA PATRIOT Act and 31 CFR 103.110." The notice can be completed and electronically submitted to FinCEN via their website. Alternatively, the notice can be mailed to the following address: FinCEN, P.O. Box 39, Mail Stop 100, Vienna, VA 22183. It is important to mention that if a financial institution or financial institution association improperly uses its Section 314(b) permissions, its certification can be revoked by either FinCEN or by its Federal Banking Agency.

Failure to follow the Section 314(b) annual certification requirements will result in the loss of the financial institution or financial institution association's statutory safe harbor and could result in a violation of privacy laws or other laws and regulations.

Verification Requirements

A financial institution must take reasonable steps to verify that the other financial institution(s) or financial institution association(s) with which it intends to share information has also performed the annual certification process discussed above. Such verification can be performed by reviewing the lists of other 314(b) participants that are periodically provided by FinCEN. Alternatively, the financial institution or financial institution association can confirm directly with the other party that the certification process has been completed.

Other Important Requirements and Restrictions

Section 314(b) requires virtually the same care and safeguarding of sensitive information as Section 314(a), whether the bank is the "provider" or "receiver" of

information. Refer to the discussions provided above and within "Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions" for detailed guidance on:

- SAR Filings and
- Confidentiality of Section 314(a) Requests (including the embedded discussion entitled "Internal Financial Institution Measures for Protecting Section 314(a) Requests").

Actions taken pursuant to shared information do not affect a financial institution's obligations to comply with all BSA and OFAC rules and regulations. For example, a financial institution is still obligated to immediately contact law enforcement and its Federal regulatory agency, by telephone, when a significant reportable violation requiring immediate attention (such as one that involves the financing of terrorist activity or is of an ongoing nature) is being conducted; thereafter, a timely SAR filing is still required.

FinCEN has provided financial institutions with general instructions, registration forms, FAQs, and additional guidance relating to the Section 314(b) information sharing process. These documents are revised periodically and may be found on FinCEN's website.

CUSTOMER DUE DILIGENCE (CDD)

The cornerstone of strong BSA/AML programs is the adoption and implementation of comprehensive CDD policies, procedures, and controls for all customers, particularly those that present a higher risk for money laundering and terrorist financing. The concept of CDD incorporates and builds upon the CIP regulatory requirements for identifying and verifying a customer's identity.

The goal of a CDD program is to develop and maintain an awareness of the unique financial details of the institution's customers and the ability to relatively predict the type and frequency of transactions in which its customers are likely to engage. In doing so, institutions can better identify, research, and report suspicious activity as required by BSA regulations. Although not required by statute or regulation, an effective CDD program provides the critical framework that enables the institution to comply with regulatory requirements.

Benefits of an Effective CDD Program

An effective CDD program protects the reputation of the institution by:

- Preventing unusual or suspicious transactions in a timely manner that potentially exposes the institution to financial loss or increased expenses;
- Avoiding criminal exposure from individuals who use the institution's resources and services for illicit purposes; and
- Ensuring compliance with BSA regulations and adhering to sound and recognized banking practices.

CDD Program Guidance

CDD programs should be tailored to each institution's BSA/AML risk profile; consequently, the scope of CDD programs will vary. While smaller institutions may have more frequent and direct contact with customers than their counterparts in larger institutions, all institutions should adopt and follow an appropriate CDD program.

An effective CDD program should:

- Be commensurate with the institution's BSA/AML risk profile, paying particular attention to higher risk customers,
- Contain a clear statement of management's overall expectations and establish specific staff responsibilities, and
- Establish monitoring systems and procedures for identifying transactions or activities inconsistent with a customer's normal or expected banking activity.

Customer Risk

As part of an institution's BSA/AML risk assessment, many institutions evaluate and apply a BSA/AML risk rating to its customers. Under this approach, the institution will obtain information at account opening sufficient to develop a "customer transaction profile" that incorporates an understanding of normal and expected activity for the customer's occupation or business operations. While this practice may not be appropriate for all institutions, management of all institutions should have a thorough understanding of the money laundering or terrorist financing risks of its customer base and develop and implement the means to adequately mitigate these risks.

Due Diligence for Higher Risk Customers

Customers that pose higher money laundering or terrorist financing risks present increased exposure to institutions. Due diligence for higher risk customers is especially

critical in understanding their anticipated transactions and implementing a suspicious activity monitoring system that reduces the institution's reputation, compliance, and transaction risks. Higher risk customers and their transactions should be reviewed more closely at account opening and more frequently throughout the term of the relationship with the institution.

The USA PATRIOT Act requires special due diligence at account opening for certain foreign accounts, such as foreign correspondent accounts and accounts for senior foreign political figures. An institution's CDD program should include policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that are established or maintained for non-U.S. persons. Guidance regarding special due diligence requirements is provided in the next section entitled "Banking Services and Activities with Greater Potential for Money Laundering and Enhanced Due Diligence Procedures."

BANKING SERVICES AND ACTIVITIES WITH GREATER POTENTIAL FOR MONEY LAUNDERING AND ENHANCED DUE DILIGENCE PROCEDURES

Certain financial services and activities are more vulnerable to being exploited in money laundering and terrorist financing activities. These conduits are often utilized because each typically presents an opportunity to move large amounts of funds embedded within a large number of similar transactions. Most activities discussed in this section also offer access to international banking and financial systems. The ability of U.S. financial institutions to conduct the appropriate level of due diligence on customers of foreign banks, offshore and shell banks, and foreign branches is often severely limited by the laws and banking practices of other countries.

While international AML and Counter-Terrorist Financing (CTF) standards are improving through efforts of several international groups, U.S. financial institutions will still need effective systems in their AML and CTF programs to understand the quality of supervision and assess the integrity and effectiveness of controls in other countries. Higher risk areas discussed in this section include:

- Non-bank financial institutions (NBFIs), including money service businesses (MSBs);
- Foreign correspondent banking relationships;
- Payable-through accounts;
- Private banking activities;
- Numbered accounts;
- Pouch activities;
- Special use accounts;
- Wire transfer activities; and
- Electronic banking.

Financial institutions offering these higher risk products and services must enhance their AML and CDD procedures to ensure adequate scrutiny of these activities and the customers conducting them.

Non-Bank Financial Institutions and Money Service Businesses

Non-bank financial institutions (NBFIs) are broadly defined as institutions that offer financial services. Traditional financial institutions ("banks" for this discussion) that maintain account relationships with NBFIs are exposed to a higher risk for potential money laundering activities because these entities are less regulated and may have limited or no documentation on their customers. Additionally, banks may likewise be exposed to possible OFAC violations for unknowingly engaging in or facilitating prohibited transactions through a NBFI account relationship.

NBFIs include, but are not limited to:

- Casinos or card clubs;
- Securities brokers/dealers; and
- Money Service Businesses (MSBs)
    - currency dealers or exchangers;
    - check cashers;
    - issuers, sellers, or redeemers of traveler's checks, money orders, or stored value cards;
    - money transmitters; and
    - U.S. Post Offices (money orders).

Money Service Businesses

As indicated above, MSBs are a subset of NBFIs. Regulations for MSBs are included within 31 CFR 103.41. All MSBs were required to register with FinCEN using Form TD F 90-22.55 by December 31, 2001, or within 180 days after the business begins operations. Thereafter, each MSB must renew its registration every two years.

MSBs are a major industry, and typically operate as independent businesses. Relatively few MSBs are chains that operate in multiple states. MSBs can be sole-purpose entities but are frequently tied to another business such as a liquor store, bar, grocery store, gas station, or other multi-

purpose entity. As a result, many MSBs are frequently unaware of their legal and regulatory requirements and have been historically difficult to detect. A bank may find it necessary to inform MSB customers about the appropriate MSB regulations and requirements.

Most legitimate MSBs should not refuse to follow regulations once they have been informed of the requirements. If they do, the bank should closely scrutinize the MSBs activities and transactions for possible suspicious activity.

MSBs typically do not establish on-going customer relationships, and this is one of the reasons that MSB customers are considered higher risk. Since MSBs do not have continuous relationships with their clients, they generally do not obtain key due diligence documentation, making customer identification and suspicious transaction identification more difficult.

Banks with MSB customers also have a risk in processing third-party transactions through their payment and other banking systems. MSB transactions carry an inherent potential for the facilitation of layering. MSBs can be conduits for illicit cash and monetary instrument transactions, check kiting, concealing the ultimate beneficiary of the funds, and facilitating the processing of forged or fraudulent items such as treasury checks, money orders, traveler's checks, and personal checks.

MSB Agents

MSBs that are agents of such commonly known entities as Moneygram or Western Union should be aware of their legal requirements. Agents of such money transmitters, unless they offer another type of MSB activity, do NOT have to independently register with FinCEN, but are maintained on an agency list by the "actual" MSB (such as Western Union). However, this "actual" MSB is responsible for providing general training and information requirements to their agents and for aggregating transactions on a nationwide basis, as appropriate.

Check Cashers

FinCEN defines a check casher as a business that will cash checks and/or sell monetary or other instruments over $1,000 per customer on any given day. If a company, such as a local mini-market, will cash only personal checks up to $100 per day AND it provides no other financial services or instruments (such as money orders or money transmittals), then that company would NOT be considered a check casher for regulatory purposes or have to register as an MSB.

Exemptions from CTR Filing Requirements

MSBs are subject to BSA regulations and OFAC sanctions and, as such, should be filing CTRs, screening customers for OFAC matches, and filing SARs, as appropriate. MSBs cannot exempt their customers from CTR filing requirements like banks can, and banks may not exempt MSB customers from CTR filing, unless the "50 Percent Rule" applies.

The "50 Percent Rule" states that if a MSB derives less than 50 percent of its gross cash receipts from money service activities, then it can be exempted. If the bank exempts a MSB customer under the "50 Percent Rule," it should have documentation evidencing the types of business conducted, receipt volume, and estimations of MSB versus non-MSB activity.

Policies and Procedures for Opening and Monitoring NBFI and MSB Relationships

Banks that maintain account relationships with NBFIs or MSBs should perform greater due diligence for these customers given their higher risk profile. Management should implement the following due diligence procedures for MSBs:

- Identify all NBFI/MSB accounts;
- Determine that the business has met local licensing requirements;
- Ascertain if the MSB has registered or re-registered with FinCEN and obtain a copy of the filing or verify the filing on FinCEN's website;
- Determine if the MSB has procedures to comply with BSA regulations and OFAC monitoring;
- Establish the types and amounts of currencies/instruments handled, and any additional services provided;
- Note the targeted customer base;
- Determine if the business sends or receives international wires and the nature of the activity;
- Determine if the MSB has procedures to monitor and report suspicious activity; and
- Obtain a copy of the MSBs independent BSA review, if available.

Management should document in writing the responses to the items above and update MSB customer files at least annually. In addition, management should continue to monitor these higher risk accounts for suspicious activity. The FDIC does not expect the bank to perform an examination of the MSB; however, the bank should take

reasonable steps to document that MSB customers are aware of and are complying with appropriate regulations.

For additional information, examiners should instruct bank management to consult the FinCEN website developed specifically for MSBs. This website contains guidance, registration forms, and other materials useful for MSBs to understand and comply with BSA regulations. Bank customers who are uncertain if they are covered by the definition of MSBs can also visit this site to determine if their business activities qualify.

Foreign Correspondent Banking Relationships

Correspondent accounts are accounts that financial institutions maintain with each other to handle transactions for themselves or for their customers. Correspondent accounts between a foreign bank and U.S. financial institutions are much needed, as they facilitate international trade and investment. However, these relationships may pose a higher risk for money laundering.

Transactions through foreign correspondent accounts are typically large and would permit movement of a high volume of funds relatively quickly. These correspondent accounts also provide foreign entities with ready access to the U.S. financial system. These banks and other financial institutions may be located in countries with unknown AML regulations and controls ranging from strong to weak, corrupt, or nonexistent.

The USA PATRIOT Act establishes reporting and documentation requirements for certain high-risk areas, including:

- Special due diligence requirements for correspondent accounts and private banking accounts which are addressed in 31 CFR 103.181.
- Verification procedures for foreign correspondent account relationships which are included in 31 CFR 103.185.
- Foreign banks with correspondent accounts at U.S. financial institutions must produce bank records, including information on ownership, when requested by regulators and law enforcement, as detailed in Section 319 of the USA PATRIOT Act and codified at 31 CFR 103.185.

The foreign correspondent records detailed above are to be provided within seven days of a law enforcement request and within 120 hours of a Federal regulatory request. Failure to provide such records in a timely manner may result in the U.S. financial institution's required termination of the foreign correspondent account. Such foreign correspondent relationships need only be terminated upon the U.S. financial institution's written receipt of such instruction from either the Secretary of the Treasury or the U.S. Attorney General. If the U.S. financial institution fails to terminate relationships after receiving notification, the U.S. institution may face civil money penalties.

The Treasury was also granted broad authority by the USA PATRIOT Act (codified in 31 USC 5318[A]), allowing it to establish special measures. Such special measures can be established which require U.S. financial institutions to perform additional recordkeeping and/or reporting or require a complete prohibition of accounts and transactions with certain countries and/or specified foreign financial institutions. The Treasury may impose such special measures by regulation or order, in consultation with other regulatory agencies, as appropriate.

Shell Banks

Sections 313 and 319 of the USA PATRIOT Act implemented (by 31 CFR 103.177 and 103.185, respectively) a new provision of the BSA that relates to foreign correspondent accounts. Covered financial institutions (CFI) are prohibited from establishing, maintaining, administering, or managing a correspondent account in the U.S. for or on behalf of a foreign shell bank.

A correspondent account, under this regulation, is defined as an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign financial institution, or to handle other financial transactions related to the foreign bank. An account is further defined as any formal banking or business relationship established to provide:

- Regular services,
- Dealings, and
- Other financial transactions,

and may include:

- Demand deposits,
- Savings deposits,
- Any other transaction or asset account,
- Credit account, or
- Any other extension of credit.

A foreign shell bank is defined as a foreign bank without a physical presence in any country. Physical presence means a place of business that:

- Is maintained by a foreign bank;
- Is located at a fixed address (other than solely an electronic address or a post-office box) in a country in which the foreign bank is authorized to conduct banking activities;
- Provides at that fixed address:
  - One or more full-time employees,
  - Operating records related to its banking activities; and
- Is subject to inspection by the banking authority that licensed the foreign bank to conduct banking activities.

There is one exception to the shell bank prohibition. This exception allows a CFI to maintain a correspondent account with a foreign shell bank if it is a regulated affiliate. As a regulated affiliate, the shell bank must meet the following requirements:

- The shell bank must be affiliated with a depository institution (bank or credit union, either U.S. or foreign) in the U.S. or another foreign jurisdiction.
- The shell bank must be subject to supervision by the banking authority that regulates the affiliated entity.

Furthermore, in any foreign correspondent relationship, the CFI must take reasonable steps to ensure that such an account is not being used indirectly to provide banking services to other foreign shell banks. If the CFI discovers that a foreign correspondent account is providing indirect services in this manner, then it must either prohibit the indirect services to the foreign shell bank or close down the foreign correspondent account. This activity is referred to as "nested" correspondent banking and is discussed in greater detail below under "Foreign Correspondent Banking Money Laundering Risks."

Required Recordkeeping on Correspondent Banking Accounts

As mentioned previously, a CFI that maintains a foreign correspondent account must also maintain records identifying the owners of each foreign bank. To minimize recordkeeping burdens, ownership information is not required for:

- Foreign banks that file form FR-7 with the Federal Reserve, or
- Publicly traded foreign banks.

A CFI must also record the name and street address of a person who resides in the U.S. and who is willing to accept service of legal process on behalf of the foreign institution. In other words, the CFI must collect information so that law enforcement can serve a subpoena or other legal document upon the foreign correspondent bank.

Certification Process

To facilitate information collection, the Treasury, in coordination with the banking industry, Federal regulators and law enforcement agencies, developed a certification process using special forms to standardize information collection. The use of these forms is not required; however, the information must be collected regardless. The CFI must update, or re-certify, the foreign correspondent information at least once every three years.

For new accounts, this certification information must be obtained within 30 calendar days after the opening date. If the CFI is unable to obtain the required information, it must close all correspondent accounts with that foreign bank within a commercially reasonable time. The CFI should review certifications to verify their accuracy. The review should look for potential problems that may warrant further research or information. Should a CFI know, suspect, or have reason to suspect that any certification information is no longer correct, the CFI must request the foreign bank to verify or correct such information within 90 days. If the information is not corrected within that time, the CFI must close all correspondent accounts with that institution within a commercially reasonable time.

Foreign Correspondent Banking Money Laundering Risks

Foreign correspondent accounts provide clearing access to foreign financial institutions and their customers, which may include other foreign banks. Many U.S. financial institutions fail to ascertain the extent to which the foreign banks will allow other foreign banks to use their U.S. accounts. Many high-risk foreign financial institutions have gained access to the U.S. financial system by operating through U.S. correspondent accounts belonging to other foreign banks. These are commonly referred to as "nested" correspondent banks.

Such nested correspondent bank relationships result in the U.S. financial institution's inability to identify the ultimate customer who is passing a transaction through the foreign correspondent's U.S. account. These nested relationships may prevent the U.S. financial institution from effectively complying with BSA regulations, suspicious activity reporting, and OFAC monitoring and sanctions.

If a U.S. financial institution's due diligence or monitoring system identifies the use of such nested accounts, the U.S.

financial institution should do one or more of the following:

- Perform due diligence on the nested users of the foreign correspondent account, to determine and verify critical information including, but not limited to, the following:
  - Ownership information,
  - Service of legal process contact,
  - Country of origin,
  - AML policies and procedures,
  - Shell bank and licensing status,
  - Purpose and expected volume and type of transactions;
- Restrict business through the foreign correspondent's accounts to limited transactions and/or purposes; and
- Terminate the initial foreign correspondent account relationship.

Necessary Due Diligence on Foreign Correspondent Accounts

Because of the heightened risk related to foreign correspondent banking, the U.S. financial institution needs to assess the money laundering risks associated with each of its correspondent accounts. The U.S. financial institution should understand the nature of each account holder's business and the purpose of the account. In addition, the U.S. financial institution should have an expected volume and type of transaction anticipated for each foreign bank customer.

When a new relationship is established, the U.S. financial institution should assess the management and financial condition of the foreign bank, as well as its AML programs and the home country's money laundering regulations and supervisory oversight. These due diligence measures are in addition to the minimum regulation requirements.

Each U.S. financial institution maintaining foreign correspondent accounts must establish appropriate, specific, and, where necessary, enhanced due diligence policies, procedures, and controls as required by 31 CFR 103.181. The U.S. financial institution's AML policies and programs should enable it to reasonably detect and report instances of money laundering occurring through the use of foreign correspondent accounts.

The regulations specify that additional due diligence must be completed if the foreign bank is:

- Operating under an offshore license;
- Operating under a license granted by a jurisdiction designated by the Treasury or an intergovernmental agency (such as the Financial Action Task Force [FATF]) as being a primary money laundering concern; or
- Located in a bank secrecy or money laundering haven.

Internal financial institution policies should focus compliance efforts on those accounts that represent a higher risk of money laundering. U.S. financial institutions may use their own risk assessment or incorporate the best practices developed by industry and regulatory recommendations.

Offshore Banks

An offshore bank is one which does not transact business with the citizens of the country that licenses the bank. For example, a bank is licensed as an offshore bank in Spain. This institution may do business with anyone in the world except for the citizens of Spain. Offshore banks are typically a revenue generator for the host country and may not be as closely regulated as banks that provide financial services to the host country's citizens. The host country may also have lax AML standards, controls, and enforcement. As such, offshore licenses can be appealing to those wishing to launder illegally obtained funds.

The FATF designates Non-Cooperative Countries and Territories (NCCTs). These countries have been so designated because they have not applied the recommended international anti-money laundering standards and procedures to their financial systems. The money laundering standards established by FATF are known as the Forty Recommendations. Further discussion of the Forty Recommendations and NCCTs can be found at the FATF website.

Payable Through Accounts

A payable through account (PTA) is a demand deposit account through which banking agencies located in the U.S. extend check writing privileges to the customers of other domestic or foreign institutions. PTAs have long been used in the U.S. by credit unions (for example, for checking account services) and investment companies (for example, for checking account services associated with money market management accounts) to offer customers the full range of banking services that only a commercial bank has the ability to provide.

International PTA Use

Under an international PTA arrangement, a U.S. financial institution, Edge corporation, or the U.S. branch or agency of a foreign bank (U.S. banking entity) opens a master

checking account in the name of a foreign bank operating outside the U.S. The master account is subsequently divided by the foreign bank into "sub-accounts" each in the name of one of the foreign bank's customers. Each sub-account holder becomes a signatory on the foreign bank's account at the U.S. banking entity and may conduct banking activities through the account.

Financial institution regulators have become aware of the increasing use of international PTAs. These accounts are being marketed by U.S. financial institutions to foreign banks that otherwise would not have the ability to offer their customers direct access to the U.S. banking system. While PTAs provide legitimate business benefits, the operational aspects of the account make it particularly vulnerable to abuse as a mechanism to launder money. In addition, PTAs present unique safety and soundness risks to banking entities in the U.S.

Sub-account holders of the PTA master accounts at the U.S. banking entity may include other foreign banks, rather than just individuals or corporate accounts. These second-tier foreign banks then solicit individuals as customers. This may result in thousands of individuals having signatory authority over a single account at a U.S. banking entity. The PTA mechanism permits the foreign bank operating outside the U.S. to offer its customers, the sub-account holders, U.S. denominated checks and ancillary services, such as the ability to receive wire transfers to and from sub-accounts and to cash checks. Checks are encoded with the foreign bank's account number along with a numeric code to identify the sub-account.

Deposits into the U.S. master account may flow through the foreign bank, which pools them for daily transfer to the U.S. banking entity. Funds may also flow directly to the U.S. banking entity for credit to the master account, with further credit to the sub-account.

Benefits Associated with Payable Through Accounts

While the objectives of U.S. financial institutions marketing PTAs and the foreign banks which subscribe to the PTA service may vary, essentially three benefits currently drive provider and user interest:

- PTAs permit U.S. financial institutions to attract dollar deposits from the home market of foreign banks without jeopardizing the foreign bank's relationship with its clients.
- PTAs provide fee income potential for both the U.S. PTA provider and the foreign bank.
- Foreign banks can offer their customers efficient and low-cost access to the U.S. banking system.

Risks Associated with Payable Through Accounts

The PTA arrangement between a U.S. banking entity and a foreign bank may be subject to the following risks:

- *Money Laundering risk* – the risk of possible illegal or improper conduct flowing through the PTAs.
- *OFAC risk* – the risk that the U.S. banking entity does not know the ultimate PTA customers which could facilitate the completion of sanctioned or blocked transactions.
- *Credit risk* - the risk the foreign bank will fail to perform according to the terms and conditions of the PTA agreement, either due to bankruptcy or other financial difficulties.
- *Settlement risk* - the risk that arises when the U.S. banking entity pays out funds before it can be certain that it will receive the corresponding deposit from the foreign bank.
- *Country risk* - the risk the foreign bank will be unable to fulfill its international obligations due to domestic strife, revolution, or political disturbances.
- *Regulatory risk* - the risk that deposit and withdrawal transactions through the PTA may violate State and/or Federal laws and regulations.

Unless a U.S. banking entity is able to identify adequately, and understand the transactions of the ultimate users of the foreign bank's account maintained at the U.S. banking entity, there is a potential for serious illegal conduct.

Because of the possibility of illicit activities being conducted through PTAs at U.S. banking entities, financial institution regulators believe it is inconsistent with the principles of safe and sound banking for U.S. banking entities to offer PTA services without developing and maintaining policies and procedures designed to guard against the possible improper or illegal use of PTA facilities.

Policy Recommendations

Policies and procedures must be fashioned to enable each U.S. banking entity offering PTA services to foreign banks to:

- Identify sufficiently the ultimate users of its foreign bank PTAs, including obtaining (or having the ability to obtain) substantially the same type of information on the ultimate users as the U.S. banking entity obtains for its domestic customers.
- Review the foreign bank's own procedures for identifying and monitoring sub-account holders, as

well as the relevant statutory and regulatory requirements placed on the foreign bank to identify and monitor the transactions of its own customers by its home country supervisory authorities.
- Monitor account activities conducted in the PTAs with foreign banks and report suspicious or unusual activity in accordance with Federal regulations.

Termination of PTAs

It is recommended the U.S. banking entity terminate a PTA with a foreign bank as expeditiously as possible in the following situations:

- Adequate information about the ultimate users of the PTAs cannot be obtained.
- The U.S. banking entity cannot adequately rely on the home country supervisor to require the foreign bank to identify and monitor the transactions of its own customers.
- The U.S. banking entity is unable to ensure that its PTAs are not being used for money laundering or other illicit purposes.
- The U.S. banking entity identifies ongoing suspicious and unusual activities dominating the PTA transactions.

Private Banking Activities

Private banking has proven to be a profitable operation and is a fast-growing business in U.S. financial institutions. Although the financial service industry does not use a standard definition for private banking, it is generally held that private banking services include an array of all-inclusive deposit account, lending, investment, trust, and cash management services offered to high net worth customers and their business interests. Not all financial institutions operate private banking departments, but they typically offer special attention to their best customers and ensure greater privacy concerning the transactions and activities of these customers. Smaller institutions may offer similar services to certain customers while not specifically referring to this activity as private banking.

Confidentiality is a vital element in administering private banking relationships. Although customers may choose private banking services to manage their assets, they may also seek confidential ownership of their assets or a safe, legal haven for their capital. When acting as a fiduciary, financial institutions may have statutory, contractual, or ethical obligations to uphold customer confidentiality.

Typically, a private banking department will service a financial institution's wealthy foreign customers, as these customers may be conducting more complex transactions and using services that facilitate international transactions. Because of these attributes, private banking also appeals to money launderers.

Examiners should evaluate the financial institution management's ability to measure and control the risk of money laundering in the private banking area and determine if adequate AML policies, procedures, and oversight are in place to ensure compliance with laws and regulations and adequate identification of suspicious activities.

Policy Recommendations

At a minimum, the financial institution's private banking policies and procedures should address:

- Acceptance and approval of private banking clients;
- Desired or targeted client base;
- Products and services that will be offered;
- Effective account opening procedures and documentation requirements; and
- Account review upon opening and ongoing thereafter.

In addition, the financial institution must:

- Document the identity and source of wealth on all customers requesting custody or private banking services;
- Understand each customer's net worth, account needs, as well as level and type of expected activity;
- Verify the source and accuracy of private banking referrals;
- Verify the origins of the assets or funds when transactions are received from other financial service providers;
- Review employment and business information, income levels, financial statements, net worth, and credit reports; and
- Monitor the account relationship by:
    - Reviewing activity against customer profile expectations,
    - Investigating extraordinary transactions,
    - Maintaining an administrative file documenting the customer's profile and activity levels,
    - Maintaining documentation that details personal observations of the customer's business and/or personal life, and
    - Ensuring that account reviews are completed periodically by someone other than the private banking officer.

Financial institutions should ensure, through independent review, that private banking account officers have adequate documentation for accepting new private banking account funds and are performing the responsibilities detailed above.

Enhanced Due Diligence for Non-U.S. Persons Maintaining Private Banking Accounts

Section 312 of the USA PATRIOT Act, implemented by 31 CFR 103.181, requires U.S. financial institutions that maintain private banking accounts for non-U.S. persons to establish enhanced due diligence policies, procedures, and controls that are designed to detect and report money laundering.

Private banking accounts subject to requirements under Section 312 of the USA PATRIOT Act include:

- Accounts, or any combination of accounts with a minimum deposit of funds or other assets of at least $1 million;
- Accounts established for one or more individuals (beneficial owners) that are neither U.S. citizens, nor lawful permanent residents of the U.S.; or
- Accounts assigned to or managed by an officer, employee, or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account.

Regulations for private banking accounts specify that enhanced due diligence procedures and controls should be established where appropriate and necessary with respect to the applicable accounts and relationships. The financial institution must be able to show it is able to reasonably detect suspicious and reportable money laundering transactions and activities.

A due diligence program is considered reasonable if it focuses compliance efforts on those accounts that represent a high risk of money laundering. Private banking accounts of foreign customers inherently indicate higher risk than many U.S. accounts; however, it is incumbent upon the financial institution to establish a reasonable level of monitoring and review relative to the risk of the account and/or department.

A financial institution may use its own risk assessment or incorporate industry best practices into its due diligence program. Specific due diligence procedures required by Section 312 of USA PATRIOT Act include:

- Verification of the identity of the nominal and beneficial owners of an account;
- Documentation showing the source of funds; and
- Enhanced scrutiny of accounts and transactions of senior foreign political figures, also known as "politically exposed persons" (PEPs).

Identity Verification

The financial institution is expected to take reasonable steps to verify the identity of both the nominal and the beneficial owners of private banking accounts. Often, private banking departments maintain customer information in a central confidential file or use code names in order to protect the customer's privacy. Because of the nature of the account relationship with the bank liaison and the focus on a customer's privacy, customer profile information has not always been well documented.

Other methods used to maintain customer privacy include:

- Private Investment Corporation (PIC),
- Offshore Trusts, and
- Token Name Accounts.

PICs are established to hold a customer's personal assets in a separate legal entity. PICs offer confidentiality of ownership, hold assets centrally, and provide intermediaries between private banking customers and the potential beneficiaries of the PICs or trusts. A PIC may also be a trust asset. PICs are incorporated frequently in countries that impose low or no taxes on company assets and operations, or are bank secrecy havens. They are sometimes established by the financial institution for customers through their international affiliates – some high profile or political customers have a legitimate need for a higher degree of financial privacy. However, financial institutions should exercise extra care when dealing with beneficial owners of PICs and associated trusts because they can be misused to conceal illegal activities. Since PICs issue bearer shares, anonymous relationships in which the financial institution does not know and document the beneficial owner should not be permitted.

Offshore trusts can operate similarly to PICs and can even include PICs as assets. Beneficial owners may be numerous; regardless, the financial institution must have records demonstrating reasonable knowledge and due diligence of beneficiary identities. Offshore trusts should identify grantors of the trusts and sources of the grantors' wealth.

Furthermore, OFAC screening may be difficult or impossible when transactions are conducted through PICs, offshore trusts, or token name accounts that shield true identities. Management must ensure that accounts

maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Documentation of Source of Funds

Documentation of the source of funds deposited into a private banking account is also required by Section 312 of the USA PATRIOT Act. Customers will frequently transfer large sums in single transactions and the financial institution must document initial and ongoing monetary flows in order to effectively identify and report suspicious activity. Understanding how high net worth customers' cash flows, operational income, and expenses flow through a private banking relationship is an integral part of understanding the customer's wealth picture. Due diligence will often necessitate that the financial institution thoroughly investigate the customer's expected transactions.

Enhanced Scrutiny of Politically Exposed Persons

Enhanced scrutiny of accounts and transactions involving senior foreign political figures, their families and associates is required by law in order to guard against laundering the proceeds of foreign corruption.

Illegal activities related to foreign corruption were brought under the definition of money laundering by Section 315 of USA PATRIOT Act. Abuses and corruption by political officials not only negatively impacts their home country's finances, but can also undermine international government and working group efforts against money laundering. A financial institution doing business with corrupt PEPs can be exposed to significant reputational risk, which could result in adverse financial impact through news articles, loss of customers, and even civil money penalties (CMPs). Furthermore, a financial institution, its directors, officers, and employees can be exposed to criminal charges if they did know or should have known (willful blindness) that funds stemmed from corruption or serious crimes.

As such, PEP accounts can present a higher risk. Enhanced scrutiny is appropriate in the following situations:

- Customer asserts a need to have the foreign political figure or related persons remain secret.
- Transactions are requested to be performed that are not expected given the customer's account profile.
- Amounts and transactions do not make sense in relation to the PEP's known income sources and uses.
- Transactions exceed reasonable amounts in relation to the PEP's known net worth.
- Transactions are large in relation to the PEP's home country financial condition.
- PEP's home country is economically depressed, yet the PEP's home country transactions funding the account remain high.
- Customer refuses to disclose the nominal or beneficial owner of the account or provides false or misleading information.
- Net worth and/or source of funds for the PEP are unidentified.

Additional discussion of due diligence procedures for these accounts can be found in interagency guidance issued in FDIC FIL-6-2001, dated in January 2001, "Guidance on Enhanced Scrutiny for Transactions That May Involve the Proceeds of Foreign Official Corruption."

Fiduciary and Custody Services within the Private Banking Department

Although fiduciary and agency activities are circumscribed by formal trust laws, private banking clients may delegate varying degrees of authority (discretionary versus nondiscretionary) over assets under management to the financial institution. In all cases, the terms under which the assets are managed are fully described in a formal agreement, also known as the "governing instrument" between the customer and the financial institution.

Even though the level of authority may encompass a wide range of products and services, examiners should determine the level of discretionary authority delegated to private banking department personnel in the management of these activities and the documentation required from customers to execute transactions on their behalf**.** Private banking department personnel should not be able to execute transactions on behalf of their clients without proper documentation from clients or independent verification of client instructions**.**

Concerning investments, fiduciaries are also required to exercise prudent investment standards, so the financial institution must ensure that if it is co-trustee or under direction of the customer who retains investment discretion, that the investments meet prudent standards and are in the best interest of the beneficiaries of the trust accounts.

Trust agreements may also be structured to permit the grantor/customer to continue to add to the corpus of the trust account. This provides another avenue to place funds

into the banking system and may be used by money launderers for that purpose.

Investment management services have many similar characteristics to trust accounts. The accounts may be discretionary or nondiscretionary. Transactions from clients through a private banking department relationship manager should be properly documented and able to be independently verified. The portfolio manager should also document the investment objectives.

Custodial services offered to private banking customers include securities safekeeping, receipts and disbursements of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including referrals from other departments in the financial institution or from outside investment advisors. The customer, or designated financial advisor, retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed, again by the customer. In this case, it is important for the financial institution to know the customer. Procedures for proper administration should be established and reviewed frequently.

Numbered Accounts

A numbered account, also known as a pseudonym account, is opened not under an individual or corporate name, but under an assigned number or pseudonym. These types of numbered accounts are typically services offered in the private banking department or the trust department, but they can be offered anywhere in the institution.

Numbered accounts present some distinct customer advantages when it comes to privacy. First, all of the computerized information is recorded using the number or pseudonym, not the customer's real name. This means that tellers, wire personnel, and various employees do not know the true identity of the customer. Furthermore, it protects the customer against identity theft. If electronic financial records are stolen, the number or pseudonym will not provide personal information. Statements and any documentation would simply show the number, not the customer's true name or social security number.

However, numbered accounts offered by U.S. financial institutions must still meet the requirements of the BSA and specific customer identification and minimum due diligence documentation should be obtained. Account opening personnel must adequately document the customer due diligence performed, and access to this information must be provided to employees reviewing transactions for suspicious activity.

If the financial institution chooses to use numbered accounts, they must ensure that proper procedures are in place. Here are some minimum standards for numbered or pseudonym accounts:

- The BSA Officer should ensure that all required CIP information is obtained and well documented. The documentation should be readily available to regulators upon request.
- Management should ensure that adequate suspicious activity review procedures are in place. These accounts are considered to be high risk, and, as such, should have enhanced scrutiny. In order to properly monitor for unusual or suspicious activities, the person(s) responsible for monitoring these accounts must have the identity of the customer revealed to them. All transactions for these accounts should be reviewed at least once a month or more frequently.
- The financial institution's system for performing OFAC reviews, Section 314(a) Requests, or any other inquiries on its customer databases, must be able to check the actual names and relevant information of these individuals. Typically the software will screen just the account name on the trial balance. Consequently, if the name is not on the trial balance, then it could be overlooked in this process. Management should thoroughly document how it will handle such situations, as well as each review that is performed.

Examiners should include the fact that the financial institution's policy allows for numbered accounts on the "Confidential – Supervisory Section" page of the Report of Examination. Given the high risk nature of this account type, examiners should review them at every examination to ensure that management is adequately handling these accounts.

Pouch Activities

Pouch activities involve the use of a common carrier to transport currency, monetary instruments, and other documents usually from outside the U.S. to a domestic bank account. Pouches can originate from an individual or another financial institution and can contain any kind of document, including all forms of bank transactions such as demand deposits and loan payments. The contents of the pouch are not always subject to search while in transport, and considerable reliance is placed on the financial institution's internal control systems designed to account

for the contents and their transfer into the institution's accounts.

Vulnerabilities in pouch systems can be exploited by those looking for an avenue to move illegally-gained funds into the U.S. Law enforcement has uncovered money laundering schemes where pouches were used to transfer:

- Bulk currency, both U.S. and foreign, and
- Sequentially numbered monetary instruments, such as traveler's checks and money orders.

Once these illegal funds are deposited into the U.S. financial institution, they can be moved – typically through use of a wire transfer – anywhere in the world. As such, pouches are used by those looking to legitimize proceeds and obscure the true source of the funds.

Financial institutions establish pouch activities primarily to provide a service. The risks associated with a night deposit drop box (one example of pouch activity) are very different from financial institutions that provide document and currency transport from their international offices to banking offices in the U.S.

A prime benefit of having pouch services is the speed with which international transactions can be placed in the U.S. domestic banking system by avoiding clearing a transaction through several international banks in order to move the funds into the U.S. This benefit is particularly advantageous for customers in countries that do not do direct business with the U.S., including those countries that:

- May require little or no customer identification,
- Are well-known secrecy havens, or
- Are considered NCCTs.

Examination Guidance

Examiners should ascertain if a financial institution offers pouch services. If it does provide these services, examiners must verify that all pouch activity is included in AML programs and is thoroughly monitored for suspicious activity.

Examiners are strongly encouraged to be present during one or more pouch openings during the examination. By reviewing the procedures for opening and documenting items in the pouches, along with records maintained of pouch activities, examiners should be able to ascertain or confirm the degree of risk undertaken and the sufficiency of AML program in relation to the institution's pouch activity.

Special Use Accounts

Special use accounts are in-house accounts established to handle the processing of multiple customer transactions within the financial institution. These accounts are also known as concentration accounts, omnibus, or suspense accounts and serve as settlement accounts. They are used in many areas of a financial institution, including private banking departments and in the wire transfer function. They present heightened money laundering risks because controls may be lax and an audit trail of customer information may not be easy to follow since transactions do not always maintain the customer identifying information with the transaction amount. In addition, many financial institution employees may have access to the account and have the ability to make numerous entries into and out of the account. Balancing of the special use account is also not always the responsibility of one individual, although items posted in the account are usually expected to be processed or resolved and settled in one day.

Financial institutions that use special use accounts should implement risk-based procedures and controls covering access to and operation of these accounts. Procedures and controls should ensure that the audit trail provides for association of the identity of transactor, customer and/or direct or beneficial owner with the actual movement of the funds. As such, financial institutions must maintain complete records of all customer transactions passing through these special use accounts. At a minimum, such records should contain the following information:

- Customer name,
- Customer address,
- Account number,
- Dollar value of the transaction, and
- Dates the account was affected.

Wire Transfer Activities

The established wire transfer systems permit quick movement of funds throughout the U.S. banking system and internationally. Wire transfers are commonly used to move funds in various money laundering schemes. Successive wire transfers allow the originator and the ultimate beneficiary of the funds to:

- Obtain relative anonymity,
- Obfuscate the money trail,
- Easily aggregate funds from a large geographic area,
- Move funds out of or into the U.S., and
- "Legitimize" illegal proceeds.

Financial institutions use two wire transfer systems in the U.S., the Fedwire and the Clearing House Interbank Payments System (CHIPS). A telecommunications network, the Society for Worldwide Interbank Financial Telecommunications (SWIFT), is often used to send messages with international wire transfers.

Fedwire transactions are governed by the Uniform Commercial Code Article 4a and the Federal Reserve Board's Regulation J. These laws primarily facilitate business conduct for electronic funds transfers; however, financial institutions must ensure they are using procedures for identification and reporting of suspicious and unusual transactions.

Wire Transfer Money Laundering Risks

Although wire systems are used in many legitimate ways, most money launderers use wire transfers to aggregate funds from different sources and move them through accounts at different banks until their origin cannot be traced. Money laundering schemes uncovered by law enforcement agencies show that money launderers aggregate funds from multiple accounts at the same financial institution, wire those funds to accounts held at other U.S. financial institutions, consolidate funds from these larger accounts, and ultimately wire the funds to offshore accounts in countries where laws are designed to facilitate secrecy. In some cases the monies are then sent back into the U.S. with the appearance of being legitimate funds.

It can be challenging for financial institutions to identify suspicious transactions due to the:

- Large number of wire transactions that occur in any given day;
- Size of wire transactions;
- Speed at which transactions move and settle; and
- Weaknesses in identifying the customers (originators and/or beneficiaries) of such transactions at the sending or receiving banks.

A money launderer will often try to make wire transfers appear to be for a legitimate purpose, or may use "shell companies" (corporations that exist only on paper, similar to shell banks discussed above in the section entitled "Foreign Correspondent Banking Relationships"), often chartered in another country. Money launderers usually look for legitimate businesses with high cash sales and high turnover to serve as a front company.

Mitigation of Wire Transfer Money Laundering Risks

Familiarity with the customer and type of business enables the financial institution to more accurately analyze transactions and thereby identify unusual wire transfer activity. With appropriate CDD policies and procedures, financial institutions should have some expectation of the type and volume of activity in accounts, especially if the account belongs to a high-risk entity or the customer uses higher-risk products or services. Consideration should be given to the following items in arriving at this expectation:

- Type and size of business;
- Customer's stated explanation for activity;
- Historical customer activity; and
- Activity of other customers in the same line of business.

Wire Transfer Recordkeeping Requirements

BSA recordkeeping rules require the retention of certain information for funds transfers and the transmittal of funds. Basic recordkeeping requirements are established in 31 CFR 103.33 and require the maintenance of the following records on all wire transfers originated over $3,000:

- Name and address of the originator,
- Amount of the payment order,
- Execution date of the payment order,
- Payment instructions received from the originator,
- Identity of the beneficiary's financial institution, and
- As many of the following items that are received with the transfer order:
  - Name and address of the beneficiary,
  - Account number of the beneficiary, and
  - Any other specific identifier of the beneficiary.

In addition, as either an intermediary bank or a beneficiary bank, the financial institution must retain a complete record of the payment order. Furthermore, the $3,000 minimum limit for retention of this information does not mean that wire transfers under this amount should not be reviewed or monitored for unusual activity.

Funds Transfer Record Keeping and Travel Rule Regulations

Along with the BSA recordkeeping rules, the Funds Transfer Recordkeeping and Travel Rule Regulations became effective in May of 1996. The regulations call for standard recordkeeping requirements to ensure all institutions are obtaining and maintaining the same information on all wire transfers of $3,000 or more. Like the BSA recordkeeping requirements, these additional recordkeeping requirements were put in place to create a

paper trail for law enforcement to investigate money laundering schemes and other illegal activities.

Industry best practices dictate that domestic institutions should encourage all foreign countries to attach the identity of the originator to wire information as it travels to the U.S. and to other countries. Furthermore, the financial institution sending or receiving the wire cannot ensure adequate OFAC verification if they do not have all of the appropriate originator and beneficiary information on wire transfers.

Necessary Due Diligence on Wire Transfer Customers

To comply with these standards and regulations, a financial institution needs to know its customers. The ability to trace funds and identify suspicious and unusual transactions hinges on retaining information and a strong knowledge of the customer developed through comprehensive CDD procedures. Financial institution personnel must know the identity and business of the customer on whose behalf wire transfers are sent and received. Wire room personnel must be trained to identify suspicious or unusual wire activities and have a strong understanding of the bank's OFAC monitoring and reporting procedures.

Review and monitoring activity should also take place subsequent to sending or receiving wires to further aid in identification of suspicious transactions. Reviewers should look for:

- Unusual wire transfer activity patterns;
- Transfers to and from high-risk countries; or
- Any of the "red flags" relating to wire transfers (refer to the "Identification of Suspicious Transactions" discussion included within this chapter.)

Risks Associated with Wire Transfers Sent with "Pay Upon Proper Identification" Instructions

Financial institutions should also be particularly cautious of wire transfers sent or received with "Pay Upon Proper Identification" (PUPID) instructions. PUPID transactions allow the wire transfer originator to send funds to a financial institution location where an individual or business does not have an account relationship. Since the funds receiver does not have an account at the financial institution, he/she must show prior identification to pick up the funds, hence the term PUPID. These transactions can be legitimate, but pose a higher than normal money laundering risk.

Electronic Banking

Electronic banking (E-Banking) consists of electronic access (through direct personal computer connection, the Internet, or other means) to financial institution services, such as opening deposit accounts, applying for loans, and conducting transactions. E-banking risks are not as significant at financial institutions that have a stand-alone "information only" website with no transactional or application capabilities. Many financial institutions offer a variety of E-banking services and it is very common to obtain a credit card, car loan, or mortgage loan on the Internet without ever meeting face-to-face with a financial institution representative.

The financial institution should have established policies and procedures for authenticating new customers obtained through E-banking channels. Customer identification policies and procedures should meet the minimum requirements of the USA PATRIOT Act and be sufficient to cover the additional risks related to customers opening accounts electronically. New account applications submitted over the Internet increase the difficulty of verifying the application information. Many financial institutions choose to require the prospective customer to come into an office or branch to complete the account opening process, while others will not. If a financial institution completes the entire application process over the Internet, it should consider using third-party databases or vendors to provide:

- Positive verification, which ensures that material information provided by an applicant matches information from third-party sources;
- Negative verification, which ensures that information provided is not linked to previous fraudulent activity; and
- Logical verification, which ensures that the information is logically consistent.

In addition to initial verification, a financial institution must also authenticate the customer's identity each time an attempt is made to access his/her private information or to conduct a transaction over the Internet. The authentication methods involve confirming one or more of these three factors:

- Information only the user should know, such as a password or personal identification number (PIN);
- An object the user possesses, such as an automatic teller machine (ATM) card, smart card, or token; or
- Something physical of the user, such as a biometric characteristic like a fingerprint or iris pattern.

Automated Clearing House Transactions and Electronic Initiation Systems

Additionally, the National Automated Clearing House Association (NACHA) has provided standards which mandate the use of security measures for automated clearing house (ACH) transactions initiated through the Internet or electronically. These guidelines include ensuring secure access to the electronic and Internet systems in conjunction with procedures reasonably designed to identify the ACH originator.

Interagency guidance on authenticating users of technology and the identity of customers is further discussed in FDIC FIL-69-2001, "Authentication in an Electronic Environment." This FIL not only identifies the risk of access to systems and information, it also emphasizes the need to verify the identity of electronic and/or Internet customers, particularly those who request account opening and new services online.

MONITORING BANK SECRECY ACT COMPLIANCE

Section 8(s) of the Federal Deposit Insurance Act, which implements 12 U.S.C. 1818, requires the FDIC to:

- Develop regulations that require insured financial institutions to establish and maintain procedures reasonably designed to assure and monitor compliance with the BSA;
- Review such procedures during examinations; and
- Describe any problem with the procedures maintained by the insured depository institution within reports of examination.

To satisfy Section 8(s) requirements, at a minimum, examiners must review BSA at each regular safety and soundness examination. In addition, the FDIC must conduct its own BSA examination at any intervening Safety and Soundness examination conducted by a State banking authority if such authority does not review for compliance with the BSA. Section 326.8 of the FDIC's Rules and Regulations establishes the minimum BSA program requirements for all state nonmember banks, which are necessary to assure compliance with the financial recordkeeping and reporting requirements set forth within the provisions of the Treasury regulation 31 CFR 103.

Part 326.8 of the FDIC's Rules and Regulations

Minimum Requirements of the BSA Compliance Program

The BSA compliance program must be in writing and approved by the financial institution's board of directors, with approval noted in the Board minutes. Best practices dictate that Board should review and approve the policy annually. In addition, financial institutions are required to develop and implement a Customer Identification Program as part of their overall BSA compliance program. More specific guidance regarding the CIP program requirements can be found within the "Customer Identification Program" discussion within this section of the DSC Risk Management Manual of Examination Policies (DSC Manual).

A financial institution's BSA compliance program must meet four minimum requirements, as detailed in Section 326.8 of the FDIC's Rules and Regulations. The procedures necessary to establish an adequate program and assure reasonable compliance efforts designed to meet these minimum requirements are discussed in detail below:

1. *A system of internal controls.* At a minimum, the system must be designed to:

    a. Identify reportable transactions at a point where all of the information necessary to properly complete the required reporting forms can be obtained. The financial institution might accomplish this by sufficiently training tellers and personnel in other departments or by referring large currency transactions to a designated individual or department. If all pertinent information cannot be obtained from the customer, the financial institution should consider declining the transaction.
    b. Monitor, identify, and report possible money laundering or unusual and suspicious activity. Procedures should provide that high-risk accounts, services, and transactions are regularly reviewed for suspicious activity.
    c. Ensure that all required reports are completed accurately and properly filed within required timeframes. Financial institutions should consider centralizing the review and report filing functions within the banking organization.
    d. Ensure that customer exemptions are properly granted, recorded, and reviewed as appropriate, including biennial renewals of "Phase II" exemptions. Exempt accounts must be reviewed at least annually to ensure that the exemptions are still valid and to determine if any suspicious or unusual activity is occurring in the account. The

BSA compliance officer should review and initial all exemptions prior to granting and renewing them.

e. Ensure that all information sharing requests issued under Section 314(a) of the USA PATRIOT Act are checked in accordance with FinCEN guidelines and are fully completed within mandated time constraints.
f. Ensure that guidelines are established for the optional providing and sharing of information in accordance with 314(b) of the USA PATRIOT Act and the written employment verification regulations (as specified in Section 355 of the USA PATRIOT Act).
g. Ensure that the financial institution's CIP procedures comply with regulatory requirements.
h. Ensure that procedures provide for adequate customer due diligence in relation to the risk levels of customers and account types. Adequate monitoring for unusual or suspicious activities cannot be completed without a strong CDD program. The CDD program should assist management in predicting the types, dollar volume, and transaction volume the customer is likely to conduct, thereby providing a means to identify unusual or suspicious transactions for that customer.
i. Establish procedures for screening accounts and transactions for OFAC compliance that include guidelines for responding to identified matches and reporting those to OFAC.
j. Provide for adequate due diligence, monitoring, and reporting of private banking activities and foreign correspondent relationships. The level of due diligence and monitoring must be commensurate with the inherent account risk.
k. Provide for adequate supervision of employees who accept currency transactions, complete reports, grant exemptions, open new customer accounts, or engage in any other activity covered by the Financial Recordkeeping and Reporting of Currency and Foreign Transactions regulations at 31 CFR 103.
l. Establish dual controls and provide for separation of duties. Employees who complete the reporting forms should not be responsible for filing them or for granting customer exemptions.

2. *Independent testing for compliance with the BSA and Treasury's regulation 31 CFR Part 103.* Independent testing of the BSA compliance program should be conducted by the internal audit department, outside auditors, or qualified consultants. Testing must include procedures related to high-risk accounts and activities. Although not required by the regulation, this review should be conducted at least annually. Financial institutions that do not employ outside auditors or consultants or that do not operate internal audit departments can comply with this requirement by utilizing employees who are not involved in the currency transaction reporting or suspicious activity reporting functions to conduct the reviews. The BSA compliance officer, even if he/she does not participate in the daily BSA monitoring and reporting of BSA, can never suffice for an independent review.

The scope of the independent testing should be sufficient to verify compliance with the financial institution's anti-money laundering program. Additionally, all findings from the audit should be provided within a written report and promptly reported to the board of directors or appropriate committee thereof. Testing for compliance should include, at a minimum:

a. A test of the financial institution's internal procedures for monitoring compliance with the BSA, including interviews of employees who handle cash transactions and their supervisors. The scope should include all business lines, departments, branches, and a sufficient sampling of locations, including overseas offices.
b. A sampling of large currency transactions, followed by a review of CTR filings.
c. A test of the validity and reasonableness of the customer exemptions granted by the financial institution.
d. A test of procedures for identifying suspicious transactions and the filing of SARs. Such procedures should incorporate a review of reports used by management to identify unusual or suspicious activities.
e. A review of documentation on transactions that management initially identified as unusual or suspicious, but, after research, determined that SAR filings were not warranted.
f. A test of procedures and information systems to review compliance with the OFAC regulations. Such a test should include a review of the frequency of receipt of OFAC updates and interviews to determine personnel knowledge of OFAC procedures.
g. A test of the adequacy of the CDD program and the CIP. Testing procedures should ensure that established CIP standards are appropriate for the various account types, business lines, and departments. New accounts from various areas in the financial institution should be sampled to

ensure that CDD and CIP efforts meet policy requirements.

h. A review of management reporting of BSA-related activities and compliance efforts. Such a review should determine that reports provide necessary information for adequate BSA monitoring and that they capture the universe of transactions for that reporting area. (For example, the incoming wire transfer logs should contain all the incoming transfers for the time period being reviewed).

i. A test of the financial institution's recordkeeping system for compliance with the BSA.

j. Documentation of the scope of the testing procedures performed and the findings of the testing.

Independent Testing Workpaper Retention

Retention of workpapers from the independent testing or audit of BSA is expected and those workpapers must be made available to examiners for review upon request. It is essential that the scope and findings from any testing procedures be thoroughly documented. Procedures that are not adequately documented will not be accepted as being in compliance with the independent testing requirement.

3. *The designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance with BSA.* To meet the minimum requirement, each financial institution must designate a senior official within the organization to be responsible for overall BSA compliance. Other individuals in each office, department or regional headquarters should be given the responsibility for day-to-day compliance. The senior official in charge of BSA compliance should be in a position, and have the authority, to make and enforce policies. This is not intended to require that the BSA administrator be an "executive officer" under the Federal Reserve Board's Regulation O.

4. *Training for appropriate personnel.* At a minimum, the financial institution's training program must provide training for all operational personnel whose duties may require knowledge of the BSA, including, but not limited to, tellers, new accounts personnel, lending personnel, bookkeeping personnel, wire room personnel, international department personnel, and information technology personnel. In addition, an overview of the BSA requirements should be given to new employees and efforts should be made to keep executives and directors informed of changes and new developments in BSA regulations.Training should be comprehensive, conducted regularly, and clearly documented. The scope of the training should include:

- The financial institution's BSA policies and procedures;
- Identification of the three stages of money laundering (placement, layering, and integration);
- "Red flags" to assist in the identification of money laundering (similar to those provided within the "Identification of Suspicious Transactions" discussion within this chapter);
- Identification and examples of suspicious transactions;
- The purpose and importance of a strong CDD program and CIP requirements;
- Internal procedures for CTR and SAR filings;
- Procedures for reporting BSA matters, including SAR filings to senior management and the board of directors;
- Procedures for conveying any new BSA rules, regulations, or internal policy changes to all appropriate personnel in a timely manner; and
- OFAC policies and procedures.

Depending on the financial institution's needs, training materials can be purchased from banking associations, trade groups, and outside vendors, or they can be internally developed by the financial institution itself. Copies of the training materials must be available in the financial institution for review by examiners.

BSA VIOLATIONS AND ENFORCEMENT

Procedures for Citing Apparent Violations in the Report of Examination

Apparent Violations of the U.S. Department of the Treasury's regulation 31 CFR 103 - Financial Recordkeeping and Reporting of Currency and Foreign Transactions

As stated previously, Treasury's regulation 31 CFR 103 establishes the minimum recordkeeping and reporting requirements for currency and foreign transactions by financial institutions. Failure to comply with the requirements of 31 CFR 103 may result in the examiner citing an apparent violation(s). Apparent violations of 31 CFR 103 are generally for specific issues such as:

- Failure to adequately identify and report large cash transactions in a timely manner;

- Failure to report Suspicious Activities, such as deposit layering or structuring cash transactions;
- Failure to reasonably identify and verify customer identity; and
- Failure to maintain adequate documentation of financial transactions, such as the purchase or sale of monetary instruments and originating or receiving wire transfers.

All apparent violations of the BSA should be reported in the Violations of Laws and Regulations pages of the Report of Examination. When preparing written comments related to apparent violations cited as a result of deficient BSA compliance practices, the following information should be included in each citation:

- Reference to the appropriate section of the regulation;
- Nature of the apparent violation;
- Date(s) and amount of the transaction(s);
- Name(s) of the parties to the transaction;
- Description of the transaction; and
- Management's response, including planned or taken corrective action.

In preparing written comments for apparent violations of the BSA, examiners should focus solely on statements of fact, and take precautions to ensure that subjective comments are omitted. Such statements would include an examiner attributing the infraction to a cause, such as management oversight or computer error. For all violations of 31 CFR 103, the Treasury reserves the authority to determine if civil penalties should be pursued. Examiner comments on the supposed causes of apparent violations may affect the Treasury's ability to pursue a case.

Random, isolated apparent violations do not require lengthy explanations or write-ups in the Report of Examination. In such cases, the section of the regulation violated, and identification of the transaction and/or instance will suffice. Examiners are also encouraged to group violations by type. When there are several exceptions to a particular section of the regulation, for example, late CTR filing, examiners should include a minimum of three examples in the Report of Examination citation. The remainder of the violations under that specific regulation can be listed as a total, without detailing all of the information. For example, detail three late CTR filings with customer information, dates, and amounts, but list a total in the apparent violation write-up for 55 instances identified during the examination.

If an examiner chooses not to include each example in the apparent violation citation, the examiners should provide bank management with a separate list so that they can identify and, if possible, correct the particular violation. A copy of the list must also be maintained in the BSA examination workpapers.

Additionally, deficient practices may violate more than one regulation. In such circumstances, the apparent violations can be grouped together. However, all of the sections of each violated regulation must be cited. Each apparent violation must be recorded on the BSA Data Entry sheet and submitted with the Report of Examination for review and transmittal.

Apparent Violations of Section 326.8 of the FDIC Rules and Regulations

In situations where deficiencies in the BSA compliance program are serious or systemic in nature, or apparent violations result from management's inability or unwillingness to develop and administer an effective BSA compliance program, examiners should cite an apparent violation(s) of the appropriate subsection(s) of Section 326.8, within the Report of Examination. Additionally, apparent violations of 31 CFR 103 that are repeated at two or more examinations, or dissimilar apparent violations that are recurring over several examinations, may also point towards a seriously deficient compliance program. When such deficiencies persist within the financial institution, it may be appropriate for examiners to consider the overall program to be deficient and cite an apparent violation of Section 326.8.

Specifically, an apparent violation of Section 326.8(b)(1) should be cited when the weaknesses and deficiencies identified in the BSA compliance program are significant, repeated, or pervasive. Citing a Section 326.8(b)(1) violation indicates that the program is inadequate or substantially ineffective. Furthermore, these deficiencies, if uncorrected, significantly impair the institution's ability to detect and prevent potential money laundering or terrorist financing activities.

An apparent violation of Section 326.8(b)(2) should be cited when weaknesses and deficiencies cited in the Customer Identification Program mitigate the institution's ability to reasonably establish, verify and record customer identity. An apparent violation of 326.8(b)(2) would generally be associated with specific weaknesses that would be reflected in apparent violations of 31 CFR 103.121, which establishes the minimum requirements for Customer Identification Programs.

An apparent violation of Section 326.8(c) should be cited for a specific program deficiency to the extent that

deficiency is attributed to internal controls, independent testing, individual responsible for monitoring day-to-day compliance, or training. If an apparent violation of Section 326.8(c) is determined to be an isolated program weakness that does not significantly impair the effectiveness of the overall compliance program, then a Section 326.8(b) should **not** be cited. If one or more program violations are cited under Section 326.8(c), or are accompanied by notable infractions of Treasury's regulation 31 CFR 103, or management is unwilling or unable to correct the reported deficiencies, the aggregate citations would likely point toward an ineffective program and warrant the additional citing of a 326.8(b) program violation, in addition to the other program, and/or financial recordkeeping violations.

When preparing written comments related to apparent violations cited as a result of deficient BSA compliance program, as defined in Section 326.8, the following information should be included in each citation:

- Nature of the violation(s);
- Name(s) of the individual(s) responsible for coordinating and monitoring compliance with the BSA (BSA officer);
- Specific internal control deficiencies that contributed to the apparent violation(s); and
- Management's response, including planned or taken corrective action.

BSA Workpapers Evidencing Apparent Violations

BSA examination workpapers that support BSA/AML apparent violation citations, enforcement actions, SARs, and CMP referrals to the Treasury should be maintained for 5 years, since they may be needed to assist further investigation or other supervisory response. Examination workpapers should not generally be included as part of a SAR, enforcement action recommendation, or Treasury referral, but may be requested for additional supporting information during a law enforcement investigation.

Civil Money Penalties and Referrals to FinCEN

When significant apparent violations of the BSA, or cases of willful and deliberate violations of 31 CFR 103 or Section 326.8 of the FDIC's Rules and Regulations are identified at a state nonmember financial institution, examiners should determine if a recommendation for CMPs is appropriate. This assessment should be conducted in accordance with existing examiner guidance for consideration of CMPs, detailed within the DSC Manual.

Civil penalties for negligence and willful violations of BSA are detailed in 31 CFR 103.57. This section states that negligent violations of any regulations under 31 CFR 103 shall not exceed $500. Willful violations for any reporting requirement for financial institutions under 31 CFR 103 can be assessed a civil penalty up to $100,000 and no less than $25,000. CMPs may also be imposed by the FDIC for violations of final Cease and Desist Orders issued under our authority granted in Section 8(s) of the Federal Deposit Insurance Act (FDI Act). In these cases, the penalty is established by Section 8(i)(2) of the FDI Act at up to $5,000 per day for each day the violation continues. Recommendations for civil money penalties for violations of Cease and Desist Orders should be handled in accordance with outstanding FDIC Directives.

Furthermore, Section 363 of the USA PATRIOT Act increases the maximum civil and criminal penalties from $100,000 to up to $1,000,000 for violations of the following sections of the USA PATRIOT Act:

- Section 311: Special measures enacted by the Treasury for jurisdictions, financial institutions, or international transactions or accounts of primary money laundering concern;
- Section 312: Special due diligence for correspondent accounts and private banking accounts; and
- Section 313: Prohibitions on U.S. correspondent accounts with foreign shell banks.

Referring Significant Violations of the BSA to FinCEN

Financial institutions that are substantially noncompliant with the BSA should be reviewed by the FDIC for recommendation to FinCEN regarding the issuance of CMPs. FinCEN is the administrator of the BSA and has the authority to assess CMPs against any domestic financial institution, including any insured U.S. branch of a foreign bank, and any partner, director, officer, or employee of a domestic financial institution for violations of the BSA and implementing regulations. Criminal prosecution is also authorized, when warranted. However, referrals to FinCEN do not preclude the FDIC from using its authority to take formal administrative action.

Factors to consider for determining when a referral to FinCEN is warranted and the guidelines established for preparing and forwarding referral documentation are detailed in examiner guidance. When examiners identify serious BSA program weaknesses at an institution, including significant apparent violations, the examiner should consult with the Regional SACM before proceeding further.

Generally, a referral should be considered when the types and nature of apparent violations of the BSA result from a nonexistent or seriously deficient BSA and anti-money laundering compliance program; expose the financial institution to a heightened level of risk for potential money laundering activity; or demonstrate a willful or flagrant disregard for the requirements of the BSA. Normally, isolated incidences of noncompliance should not be referred for penalty consideration. Even if the type of violation was cited previously, referral would not be appropriate if the apparent violations involved are genuine misunderstandings of the BSA requirements or inadvertent violations, the deficiencies are correctable in the normal course of business and proper corrective action has been taken or committed to by management.

A referral may be warranted in the absence of previous violations if the nature of apparent violations identified at the current examination is serious. An example would be failing to file FinCEN Form 104, Currency Transaction Report, on nonexemptible businesses or businesses that, while exemptible, FinCEN, as a matter of policy will not authorize the financial institution to exempt. To illustrate, the failure to file CTRs on transactions involving an individual or automobile dealer (both nonexemptible) is of greater concern to FinCEN than a failure to file CTRs on a recently opened supermarket which has not yet been added to the bank's exempt list or a golf course where the financial institution believed that it qualified for a unilateral exemption as a sports arena. This doesn't mean that the failure to file CTRs on a supermarket should never be referred. Failure to file CTRs on a supermarket that is a front for organized crime, that has no customers yet has large receipts, or that has currency transaction activity that far exceeds its expected revenues would warrant referral.

Mitigating Factors to Consider

Other considerations in, deciding whether to recommend criminal/civil penalties include the financial institution's past history of compliance, and whether the current system of policies, procedures, systems, internal controls, and training are sufficient to ensure a satisfactory level in the future. Senior management's attitude and commitment toward compliance as evidenced by their involvement and devotion of resources to compliance programs should also be considered. Any mitigating factors should be given full consideration. Mitigating factors would include:

- The implementation of a comprehensive compliance program that ensures a high level of compliance including a system for aggregating currency transactions.
- Volunteer reporting by the institution of apparent violations discovered on its own during the course of internal audits. This does not apply to situations where examiners disclose apparent violations and the institution comes forward voluntarily to head off a possible referral.
- Positive efforts to assist law enforcement, including the reporting of suspicious transactions and the filing of Suspicious Activity Reports.

It should be noted that FinCEN does not categorize violations as substantive or technical. However, FinCEN does recognize the varying nature of violations and the fact that not all violations require a referral.

Content of a Well-Developed Referral

A well-developed referral is one that contains sufficient detail to permit FinCEN to ascertain: the number, nature and severity of apparent violations cited; the overall level of BSA compliance; the severity of any weaknesses in the financial institution's compliance program; and the financial institution's ability to achieve a satisfactory level of compliance in the future.

A summary memorandum detailing these issues should be prepared by the field examiner and submitted to the Regional Office for review. At a minimum, each referral should include a copy of this memorandum, the Report of Examination pages that discuss BSA findings, and a civil monetary penalty assessment. Documents contained in the referral package need to be conclusion-oriented and descriptive with facts supporting summary conclusions. It is not sufficient to say that the financial institution has written policies and procedures or that management provides training to employees. Referrals are much more useful when they discuss the specific deficiencies identified within the compliance programs, policies and procedures, systems, management involvement, and training.

Discussing the Referral Process with Financial Institution Management

Examiners should not advise the financial institution that a civil money penalty referral is being submitted to FinCEN. If an investigation by law enforcement is warranted, it may be compromised by disclosure of this information. It is permissible to tell management that FinCEN will be notified of all apparent violations of the BSA cited. However, examiners are not to provide any oral or written communication to the financial institution passing judgment on the willfulness of apparent violations.

Criminal Penalties

Treasury regulation 31 CFR 103.59 notifies institutions that they can be subject to criminal penalties if convicted for willful violations of the BSA of not more than $1,000 and/or one year in prison. If such a BSA violation is committed to further any other Federal law punishable by more than a year in prison (such as fraud, money laundering, theft, illegal narcotics sales, etc.) then harsher penalties can be imposed. In these cases, the perpetrator, upon conviction, can be fined not more than $10,000 and/or be imprisoned not more than 5 years.

In addition, criminal penalties may also be charged against any person who knowingly makes any false, fictitious, or fraudulent statement or representation in any BSA report. Upon conviction of such an act, the perpetrator may be fined not more than $10,000 and/or imprisoned for 5 years.

Certain violations of the BSA allow for the U.S. Government to seize the funds related to the crime. The USA PATRIOT Act amended the BSA to provide for funds forfeiture in cases dealing with foreign crimes, U.S. interbank accounts, and in connection with some currency transaction reporting violations. Furthermore, the U.S. Government can seize currency or other monetary instruments physically transported into or out of the U.S. when required BSA reports go unfiled or contain material omissions or misstatements.

Supervisory Actions

The FDIC has the authority to address less than adequate compliance with the BSA through various formal or informal administrative actions. If a specific violation of Section 326.8 or 31 CFR 103 is not corrected or the same provision of a regulation is cited from one examination to the next, Section 8(s) of the FDI Act requires the FDIC to consider formal enforcement action as described in Section 8(b) or 8(c) of the FDI Act. However, the FDIC has determined that informal enforcement action, such as a Board Resolution or a Memorandum of Understanding may be a more appropriate supervisory response, given related circumstances and events, which may serve as mitigating factors.

Violations of a technical and limited nature would not necessarily reflect an inadequate BSA program; as such, it is important to look at the type and number of violations before determining the appropriate administrative action. If the Regional Office reviews a case with significant violations, it should determine whether an enforcement action is necessary. Under such circumstances, if the Regional Office determines that a Cease and Desist action is **not** appropriate, then documentation supporting that decision should be maintained at the Regional Office and a copy of that documentation submitted to the Special Activities Section in Washington, D.C.

Memoranda of Understanding (MOU) and Board Resolutions (BBR)

In certain cases, the Regional Office may determine that a BBR or a MOU is an appropriate action to deal with an institution's BSA weaknesses. BBRs should only be used in circumstances where recommendations are minor and do not affect the overall adequacy of the institution's BSA compliance program. Unlike a BBR, a MOU is a bi-lateral agreement between the financial institution and the FDIC. When the Regional Office deems that a MOU is appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department may work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination.

Cease and Desist Orders

Section 8(s) of the FDI Act grants the FDIC the power to issue Cease and Desist Orders solely for the purpose of correcting BSA issues at state nonmember banks. In situations where BSA/AML program weaknesses expose the institution to an elevated level of risk to potential money laundering activity, are repeatedly cited at consecutive examinations, or demonstrate willful noncompliance or negligence by management, a Section 8(b) Order to Cease and Desist should be considered by the Regional Office. Cases referred to FinCEN for civil money penalties should also be reviewed for **formal** supervisory action.

When a Cease and Desist Order is deemed to be appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department should work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination. Specific details are contained in the Formal and Informal Actions Procedures (FIAP) Manual.

Removal/Prohibition Orders

If deficiencies or apparent violations of Section 326.8 or 31 CFR 103 involve negligent or egregious action or inaction by institution-affiliated parties (IAPs), other formal actions may be appropriate. In such situations where the IAP exposes the institution to an elevated risk of, or has facilitated or participated in actual transactions involving money laundering activity, utilization of Section

8(e) of the FDI Act, a removal/prohibition action, should be considered.

In cases where apparent violations of Section 326.8 and/or 31 CFR Section 103 have been committed by an IAP(s) and appear to involve criminal intent, examiners should contact the Regional SACM or other designees about filing a SAR on the IAP(s). If the involvement of the IAP(s) in the criminal activity warrants, the Regional Office should also consider contacting the Federal Bureau of Investigation (FBI) or other Federal law enforcement agency via phone or letter to provide them a referral of the SAR and indicate the FDIC's interest in pursuit of the case.

IDENTIFICATION OF SUSPICIOUS TRANSACTIONS

Effective BSA/AML compliance programs include controls and measures to identify and report suspicious transactions in a timely manner. An institution should have in place a CDD program sufficient to be able to make an informed decision about the suspicious nature of a particular transaction. This section highlights unusual or suspicious activities and transactions that may indicate potential money laundering through structured transactions, terrorist financing, and other schemes designed for illicit purposes. Often, individuals involved in suspicious activity will use a combination of several types of unusual transactions in an attempt to confuse or mislead anyone attempting to identify the true nature of their activities.

Structuring is the most common suspicious activity reported to FinCEN. Structuring is defined as breaking down a sum of currency that exceeds the $10,000 CTR reporting level per the regulation, into a series of transactions at or less than $10,000. The transactions do not need to occur on any single day in order to constitute structuring. Money launderers have developed many ways to structure large amounts of cash to evade the CTR reporting requirements. Examiners should be alert to multiple cash transactions that exceed $10,000, but may involve other monetary instruments, bank official checks, travelers' checks, savings bonds, loans and loan payments, or even securities transactions as the offsetting entry. The transactions could also involve the exchange of small bank notes for large ones, but in amounts less than $10,000. Structuring of cash transactions to evade CTR filing requirements is often the easiest of suspicious activities to identify. It is subject to criminal and civil violations of the BSA regulations as implemented within 31 CFR 130.63. This regulation states that any person who structures or assists in structuring a currency transaction at a financial institution for the purpose of evading CTR reporting, or causes or attempts to cause a financial institution to fail to file a CTR, or causes the financial institution to file a CTR that contains a material omission or misstatement of fact, is subject to the criminal and civil violations of the BSA regulations. Financial institutions are required by the BSA to have monitoring procedures in place to identify structured transactions.

Knowledge of the three stages of money laundering (discussed below) has multiple benefits for financial institutions. These benefits include, but are not limited to, the following:

- Identification and reporting of illicit activities to FinCEN,
- Prevention against losses stemming from fraud,
- Prevention against citation of apparent violations of BSA and SAR regulations, and
- Prevention against assessment of CMPs by FinCEN and/or the FDIC.

The following discussions and "red flag" lists, while not all-inclusive, identify various types of suspicious activity/transactions. These lists are intended to serve as a reference tool and should not be used to make immediate and definitive conclusions that a particular activity or series of transactions is illegal. They should be viewed as potentially suspicious warranting further review. The activity/transactions may not be suspicious if they are consistent with a customer's legitimate business.

The Three Stages of Money Laundering

There are three stages in typical money laundering schemes:

1. Placement,
2. Layering, and
3. Integration.

Placement

Placement, the first stage of money laundering, involves the placement of bulk cash into the financial system without the appearance of being connected to a criminal activity. There are many ways cash can be placed into the system. The simplest way is to deposit cash into a financial institution; however, this is also one of the riskier ways to get caught laundering money. To avoid notice, banking transactions involving cash are likely to be conducted in amounts under the CTR reporting thresholds; this activity is referred to as "structuring."

Furthermore, the use of false identities to conduct these transactions is common; banking officers should be vigilant in looking for false identification documents. In an attempt to conceal their activities, money launderers will often resort to "smurfing" activities to get illicit funds into a financial institution. "Smurfing" is the process of using several individuals to deposit illicit cash proceeds into many accounts at one or several financial institutions in a single day.

Furthermore, cash can be exchanged for traveler's checks, food stamps, or other monetary instruments, which can then also be deposited into financial institutions. Placement can also be done by purchasing goods or services, such as a travel/vacation package, insurance policies, jewelry, or other "high-ticket" items. These goods and services can then be returned to the place of purchase in exchange for a refund check, which can then be deposited at a financial institution with less likelihood of detection as being suspicious. Smuggling cash out of a country and depositing that cash into a foreign financial institution is also a form of placement. Illegally-obtained funds can also be funneled into a legitimate business as cash receipts and deposited without detection. This type of activity actually combines placement with the other two stages of money laundering, layering and integration, discussed below.

Layering

The second stage of money laundering is typically layering. This stage is the process of moving and manipulating funds to confuse their sources as well as complicating or partially eliminating the paper trail. Layering may involve moving funds in various forms through multiple accounts at numerous financial institutions, both domestic and international, in a complex series of transactions. Examples of layering transactions include:

- Transferring funds by check or monetary instrument;
- Exchanging cashier's checks and other monetary instruments for other cashier's checks, larger or smaller, possibly adding additional cash or other monetary instruments in the process;
- Performing intrabank transfers between accounts owned or controlled by common individuals (for example, telephone transfers);
- Performing wire transfers to accounts under various customer and business names at other financial institutions;
- Transferring funds outside and possibly back into the U.S. by various means such as wire transfers, particularly through "secrecy haven" countries;
- Obtaining certificate of deposit (CD) secured loans and depositing the loan disbursement check into an account (when the loan is defaulted on, there is no loss to the bank); and
- Depositing a refund check from a canceled vacation package or insurance policy.

Layering transactions may become very complex and involve several of these methods to hide the trail of funds.

Integration

The third stage of money laundering is integration, which typically follows the layering stage. However, as mentioned in the discussion of the placement stage, integration can be accomplished simultaneously with the placement of funds. After the funds have been placed into the financial system and insulated through the layering process, the integration phase is used to create the appearance of legality through additional transactions such as loans, or real estate deals. These transactions provide the criminal with a plausible explanation as to where the funds came from to purchase assets and shield the criminal from any type of recorded connection to the funds.

During the integration stage, the funds are returned in a usable format to the criminal source. This process can be achieved through various schemes, such as:

- Inflating business receipts,
- Overvaluing and undervaluing invoices,
- Creating false invoices and shipping documents,
- Establishing foreign trust accounts,
- Establishing a front company or phony charitable organization, and
- Using gold bullion schemes.

These schemes are just a few examples of the integration stage; the possibilities are not limited.

Money Laundering Red Flags

Some activities and transactions that are presented to a financial institution should raise the level of concern regarding the possibility of potential money laundering activity. Evidence of these "red flags" in an institution's accounts and transactions should prompt the institution, and examiners reviewing such activity, to consider the possibility of illicit activities. While these red flags are not evidence of illegal activity, these common indicators should be part of an expanded review of suspicious activities.

General

- **Refusal or reluctance to proceed with a transaction, or abruptly withdrawing a transaction.** A customer may be reluctant to proceed, or may even withdraw all or a portion of a transaction after being informed that a CTR will be filed, or that the purchase of a monetary instrument will be recorded. This action would be taken to avoid BSA reporting and recordkeeping requirements.

- **Customer refusal or reluctance to provide information or identification.** A customer may be reluctant, or even refuse to provide identifying information when opening an account, cashing a check, recording the purchase of a monetary instrument, or providing information necessary to file a CTR.

- **Structured or recurring, non-reportable transactions.** An individual or group may attempt to avoid BSA reporting and recordkeeping requirements by breaking up, or structuring a currency transaction or purchase of monetary instruments in amounts less than the reporting/recordkeeping thresholds. Transactions may also be conducted with multiple banks, branches, customer service representatives, accounts, and/or on different days in an attempt to avoid reporting requirements.

- **Multiple third parties conducting separate, but related, non-reportable transactions.** Two or more individuals may go to different tellers or branches and each conduct transactions just under the reporting/recordkeeping threshold. (This activity is often referred to as "smurfing.")

- **Even dollar amount transactions.** Numerous transactions are conducted in even dollar amounts.

- **Transactions structured to lose the paper trail.** The bank may be asked to process internal debits or credits containing little or no description of the transaction in an attempt to "separate" a transaction from its account.

- **Significant increases in the number or amount of transactions.** A large increase in the number or amount of transactions involving currency, the purchase of monetary instruments, wire transfers, etc., may indicate potential money laundering.

- **Transactions which are not consistent with the customer's business, occupation, or income level.** Transactions should be consistent with the customer's known business or income level.

- **Transactions by non-account holders.** A non-account holder conducts or attempts to conduct transactions such as currency exchanges, the purchase or redemption of monetary instruments, with no apparent legitimate reason.

Cash Management: Branch and Vault Shipments

- **Change in currency shipment patterns.** Significant changes in currency shipment patterns between vaults, branches and/or correspondent banks as noted on cash shipment records may indicate a potential money laundering scheme occurring in a particular location.

- **Large increase in the cash supply.** A large, sustained increase in the cash balance would normally cause some increase in the number of CTRs filed. Another example of a red flag in this area would be a rapid increase in the size and frequency of cash deposits with no corresponding increase in non-cash deposits.

- **Currency shipments to or from remote locations**. Unusually large transactions between a small, remote bank and a large metropolitan bank may also indicate potential money laundering.

- **Significant exchanges of small denomination bills for large denomination bills**. Significant increases resulting from the exchange of small denominations for large denominations may be reflected in the cash shipment records.

- **Significant requirement for large bills.** Branches whose large bill requirements are significantly greater than the average may be conducting large currency exchanges. Branches that suddenly stop shipping large bills may be using them for currency exchanges.

- **International cash shipments funded by multiple monetary instruments.** This involves the receipt of funds in the form of multiple official bank checks, cashier's checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions. They may be made payable to the same individual or business, or related individuals or businesses, and may be in U.S. dollar amounts that are below the BSA reporting/recordkeeping threshold. Funds are then shipped or wired to a financial institution outside the U.S.

- **Other unusual domestic or international shipments.** A customer requests an outgoing shipment or is the beneficiary of a shipment of currency, and the instructions received appear inconsistent with normal cash shipment practices. For example, the customer directs the bank to ship the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **Frequent cash shipments with no apparent business reason**. Frequent use of cash shipments that is not justified by the nature of the customer's business may be indicative of money laundering.

Currency Exchanges and Other Currency Transactions

- **Unusual exchange of denominations**. An individual or group seeks the exchange of small denomination bills (five, ten and twenty dollar bills) for large denomination bills (hundred dollar bills), without any apparent legitimate business reason.

- **Check cashing companies**. Large increases in the number and/or amount of cash transactions for check cashing companies.

- **Unusual exchange by a check cashing service.** No exchange or cash back for checks deposited by an individual who owns a check cashing service can indicate another source of cash.

- **Suspicious movement of funds.** Suspicious movement of funds out of one financial institution, into another financial institution, and back into the first financial institution can be indicative of the layering stage of money laundering.

Deposit Accounts

- **Minimal, vague or fictitious information provided**. An individual provides minimal, vague, or fictitious information that the financial institution cannot readily verify.

- **Lack of references or identification.** An individual attempts to open an account without references or identification, gives sketchy information, or refuses to provide the information needed by the financial institution.

- **Non-local address**. The individual does not have a local residential or business address and there is no apparent legitimate reason for opening an account with the bank.

- **Customers with multiple accounts.** A customer maintains multiple accounts at a bank or at different banks for no apparent legitimate reason. The accounts may be in the same names or in different names with different signature authorities. Routine inter-account transfers provide a strong indication of accounts under common control.

- **Frequent deposits or withdrawals with no apparent business source**. The customer frequently deposits or withdraws large amounts of currency with no apparent business source, or the business is of a type not known to generate substantial amounts of currency.

- **Multiple accounts with numerous deposits under $10,000**. An individual or group opens a number of accounts under one or more names, and makes numerous cash deposits just under $10,000, or deposits containing bank checks or traveler's checks, or a combination of all of these.

- **Numerous deposits under $10,000 in a short period of time**. A customer makes numerous deposits under $10,000 in an account in short periods of time, thereby avoiding the requirement to file a CTR. This includes deposits made at an ATM.

- **Accounts with a high volume of activity and low balances**. Accounts with a high volume of activity, which carry low balances, or are frequently overdrawn, may be indicative of money laundering or check kiting.

- **Large deposits and balances.** A customer makes large deposits and maintains large balances with little or no apparent justification.

- **Deposits and immediate requests for wire transfers or cash shipments**. A customer makes numerous deposits in an account and almost immediately requests wire transfers or a cash shipment from that account to another account, possibly in another country. These transactions are not consistent with the customer's legitimate business needs. Normally, only a nominal amount remains in the original account.

- **Numerous deposits of small incoming wires or monetary instruments, followed by a large outgoing wire**. Numerous small incoming wires and/or multiple monetary instruments are deposited

into an account. The customer then requests a large outgoing wire to another institution or country.

- **Accounts used as a temporary repository for funds.** The customer appears to use an account as a temporary repository for funds that ultimately will be transferred out of the financial institution, sometimes to foreign-based accounts. There is little account activity.

- **Funds deposited into several accounts, transferred to another account, and then transferred outside of the U.S.** This involves the deposit of funds into several accounts, which are then combined into one account, and ultimately transferred outside the U.S. This activity is usually not consistent with the known legitimate business of the customer.

- **Disbursement of certificates of deposit by multiple bank checks.** A customer may request disbursement of the proceeds of a certificate of deposit or other investments in multiple bank checks, each at or under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the CTR requirements and severs the paper trail.

- **Early redemption of certificates of deposits**. A customer may request early redemption of certificates of deposit or other investments within a relatively short period of time from the purchase date of the certificate of deposit or investment. The customer may be willing to lose interest and incur penalties as a result of the early redemption.

- **Sudden, unexplained increase in account activity or balance**. There may be a sudden, unexplained increase in account activity, both from cash and from non-cash items. An account may be opened with a nominal balance that subsequently increases rapidly and significantly.

- **Limited use of services.** Frequent large cash deposits are made by a corporate customer, who maintains high balances but does not use the financial institution's other services.

- **Inconsistent deposit and withdrawal activity.** Retail businesses may deposit numerous checks, but there will rarely be withdrawals for daily operations.

- **Strapped currency**. Frequent deposits of large amounts of currency, wrapped in currency straps that have been stamped by other financial institutions.

- **Client, trust and escrow accounts**. Substantial cash deposits by a professional customer into client accounts, or in-house company accounts, such as trust and escrow accounts.

- **Large amount of food stamps.** Unusually large deposits of food stamps, which may not be consistent with the customer's legitimate business.

Lending

- **Certificates of deposits used as collateral.** An individual buys certificates of deposit and uses them as loan collateral. Illegal funds can be involved in either the certificate of deposit purchase or utilization of loan proceeds.

- **Sudden/unexpected payment on loans**. A customer may suddenly pay down or pay off a large loan, with no evidence of refinancing or other explanation.

- **Reluctance to provide the purpose of the loan or the stated purpose is ambiguous**. A customer seeking a loan with no stated purpose may be trying to conceal the true nature of the loan. The BSA requires the bank to document the purpose of all loans over $10,000, with the exception of those secured by real property.

- **Inconsistent or inappropriate use of loan proceeds**. There may be cases of inappropriate disbursement of loan proceeds, or disbursements for purposes other than the stated loan purpose.

- **Overnight loans.** A customer may use "overnight" loans to create high balances in accounts.

- **Loan payments by third parties.** Loans that are paid by a third party could indicate that the assets securing the loan are really those of a third party, who may be attempting to conceal ownership of illegally, gained funds.

- **Loan proceeds used to purchase property in the name of a third party, or collateral pledged by a third party.** A customer may use loan proceeds to purchase, or may pledge as collateral, real property in the name of a trustee, shell corporation, etc.

- **Permanent mortgage financing with an unusually short maturity, particularly in the case of large mortgages.**

- **Structured down payments or escrow money transactions**. An attempt to "structure" a down payment or escrow money transaction may be made in order to conceal the true source of the funds used.

- **Attempt to sever the paper trail**. Attempts may be made by the customer or bank to sever any paper trail connecting a loan to the collateral.

- **Wire transfer of loan proceeds**. A customer may request that loan proceeds be wire transferred for no apparent legitimate reason.

- **Disbursement of loan proceeds by multiple bank checks**. A customer may request disbursement of loan proceeds in multiple bank checks, each under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the currency transaction reporting requirements and severs the paper trail.

- **Loans to companies outside the U.S.** Unusual loans to offshore customers, and loans to companies incorporated in "secrecy havens" are higher risk activities.

- **Financial statement.** Financial statement composition of a business differs greatly from those of similar businesses.

Monetary Instruments

- **Structured purchases of monetary instruments.** An individual or group purchases monetary instruments with currency in amounts below the $3,000 BSA recordkeeping threshold.

- **Replacement of monetary instruments**. An individual uses one or more monetary instruments to purchase another monetary instrument(s).

- **Frequent purchase of monetary instruments without apparent legitimate reason**. A customer may repeatedly buy a number of official bank checks or traveler's checks with no apparent legitimate reason.

- **Deposit or use of multiple monetary instruments**. The deposit or use of numerous official bank checks or other monetary instruments, all purchased on the same date at different banks or different issuers of the instruments may indicate money laundering. These instruments may or may not be payable to the same individual or business.

- **Incomplete or fictitious information**. The customer may conduct transactions involving monetary instruments that are incomplete or contain fictitious payees, remitters, etc.

- **Large cash amounts.** The customer may purchase cashier's checks, money orders, etc., with large amounts of cash.

Safe Deposit Boxes

- **Frequent visits.** The customer may visit a safe deposit box on an unusually frequent basis.

- **Out-of-area customers.** Safe deposit boxes may be opened by individuals who do not reside or work in the banks service area.

- **Change in safe deposit box traffic pattern.** There may be traffic pattern changes in the safe deposit box area. For example, more people may enter or enter more frequently, or people carry bags or other containers that could conceal large amounts of cash.

- **Large amounts of cash maintained in a safe deposit box**. A customer may access the safe deposit box after completing a transaction involving a large withdrawal of cash, or may access the safe deposit box prior to making cash deposits which are just under $10,000.

- **Multiple safe deposit boxes**. A customer may rent multiple safe deposit boxes if storing large amounts of currency.

Wire Transfers

- **Wire transfers to countries widely considered "secrecy havens."** Transfers of funds to well known "secrecy havens."

- **Incoming/outgoing wire transfers with instructions to the receiving institution to pay upon proper identification**. The instructions to the receiving bank are to "pay upon proper identification." If paid for in cash, the amount may be just under $10,000 so no CTR is required. The purchase may be made with numerous official checks or other monetary instruments. The amount of the transfer may be large, or the funds may be sent to a foreign country.

- **Outgoing wire transfers requested by non-account holders.** If paid in cash, the amount may be just under $10,000 to avoid the CTR filing requirement.

Alternatively, the transfer may be paid with several official checks or other monetary instruments. The funds may be directed to a foreign country.

- **Frequent wire transfers with no apparent business reason**. A customer's frequent wire transfer activity is not justified by the nature of their business.

- **High volume of wire transfers with low account balances.** The customer requests a high volume of incoming and outgoing wire transfers but maintains low or overdrawn account balances.

- **Incoming and outgoing wires in similar dollar amounts**. There is a pattern of wire transfers of similar amounts both into and out of the customer's account, or related customer accounts, on the same day or next day. The customer may receive many small incoming wires, and then order a large outgoing wire transfer to another city or country.

- **Large wires by customers operating a cash business**. Could involve wire transfers by customers operating a mainly cash business. The customers may be depositing large amounts of currency.

- **Cash or bearer instruments used to fund wire transfers**. Use of cash or bearer instruments to fund wire transfers may indicate money laundering.

- **Unusual transaction by correspondent financial institutions.** Suspicious transactions may include: (1) wire transfer volumes that are extremely large in proportion to the asset size of the bank; (2) when the bank's business strategy and financial statements are inconsistent with a large volume of wire transfers, particularly outside the U.S.; or (3) a large volume of wire transfers of similar amounts in and out on the same or next day.

- **International funds transfer(s) which are not consistent with the customer's business**. International transfers, to or from the accounts of domestic customers, in amounts or with a frequency that is inconsistent with the nature of the customer's known legitimate business activities could indicate money laundering.

- **International transfers funded by multiple monetary instruments**. This involves the receipt of funds in the form of multiple official bank checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions and made payable to the same individual or business, or related individuals or businesses, in U.S. dollar amounts that are below the BSA reporting threshold. The funds are then wired to a financial institution outside the U.S.

- **Other unusual domestic or international funds transfers.** The customer requests an outgoing wire or is the beneficiary of an incoming wire, and the instructions appear inconsistent with normal wire transfer practices. For example, the customer directs the bank to wire the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **No change in form of currency.** Funds or proceeds of a cash deposit may be wired to another country without changing the form of currency.

Other Activities Involving Customers and Bank Employees

- **Questions or discussions on how to avoid reporting/recordkeeping**. This involves discussions by individuals about ways to bypass the filing of a CTR or recording the purchase of a monetary instrument.

- **Customer attempt to influence a bank employee not to file a report**. This would involve any attempt by an individual or group to threaten, bribe, or otherwise corruptly influence a bank employee to bypass the filing of a CTR, the recording of purchases of monetary instruments, or the filing of a SAR.

- **Lavish lifestyles of customers or bank employees**. Lavish lifestyles of customers or employees, which are not supported by their current salary, may indicate possible involvement in money laundering activities.

- **Short-term or no vacations.** A bank employee may be reluctant to take any vacation time or may only take short vacations (one or two days).

- **Circumvention of internal control procedures**. Overrides of internal controls, recurring exceptions, and out-of-balance conditions may indicate money laundering activities. For example, bank employees may circumvent wire transfer authorizations and approval policies, or could split wire transfers to avoid ceiling limitations.

- **Incorrect or incomplete CTRs**. Employees may frequently submit incorrect or incomplete CTRs.

Terrorist Financing Red Flags

Methods used by terrorists to generate funds can be both legal and illegal. In the U.S., it is irrelevant whether terrorist funding is obtained legally or illegally; any funds provided to support terrorist activity are considered to be laundered money. Funding from both legal and illegal sources must be laundered by the terrorist in order to obscure links between the terrorist group (or cell) and its funding sources and uses. Terrorists and their support organizations typically use the same methods that criminal groups use to launder funds. In particular, terrorists appear to favor:

- Cash smuggling, both by couriers or in bulk cash shipments;
- Structured deposits and/or withdrawals;
- Purchases of monetary instruments;
- Use of credit and/or debit cards; and
- Use of underground banking systems.

While it is not the primary function of an examiner to identify terrorist financing while examining an institution for BSA compliance, examiners and financial institution management should be cognizant of suspicious activities or unusual transactions that are common indicators of terrorist financing. Institutions are encouraged to incorporate procedures into their BSA/AML compliance programs that address notifying the proper Federal agencies when serious concerns of terrorist financing activities are encountered. At a minimum, these procedures should require the institution to contact FinCEN's Financial Institutions Hotline to report such activities.

SUSPICIOUS ACTIVITY REPORTING

Part 353 of the FDIC's Rules and Regulations requires insured state nonmember banks to report known or suspected criminal offenses to the Treasury. The SAR form to be used by financial institutions is Form TD F 90-22.47 and is available on the FinCEN website. FinCEN is the repository for these reports, but content is owned by the Federal Banking Agencies. The SAR form is used to report many types of suspected criminal violations. Details of the criminal violations can be found in the Criminal Violations section of this manual.

Suspicious Activities and Transactions Requiring SAR Filings

Among the suspicious activities required to be reported are any transactions aggregating $5,000 or more that involve potential money laundering, suspected terrorist financing activities, or violations of the BSA. However, if a financial institution insider is involved in the suspicious transaction(s), a SAR must be filed at any transaction amount. Other suspected criminal activity requires filing a SAR if the transactions aggregate $5,000 or more and a suspect can be identified. If the financial institution is unable to identify a suspect, but believes it was an actual or potential victim of a criminal violation, then a SAR must be filed for transactions aggregating $25,000 or more. Although these are the required transaction levels for filing a SAR, a financial institution may voluntarily file a SAR for suspicious transactions below these thresholds. SAR filings are not used for reporting robberies to local law enforcement, or for lost, counterfeit, or stolen securities that are reported pursuant to 17 CFR 240.17f-1.

If the suspicious transaction involves currency and exceeds $10,000, the financial institution will also need to file a CTR in addition to a SAR.

For suspected money laundering and violations of the BSA, a financial institution must file a SAR, if it knows, suspects, or has reason to suspect that:

- The transaction involves funds derived from illegal activities or is intended or conducted in order to conceal funds or assets derived from illegal activities (including without limitation, the ownership, nature, source, location, or control of such funds or assets), as part of a plan to violate or evade any Federal law or regulation or to avoid any transaction reporting requirement under Federal law;
- The transaction is designed to evade any regulation promulgated under the BSA; or
- The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the financial institution knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Preparation of the SAR Form

The SAR form requires the financial institution to complete detailed information about the suspect(s) of the transaction, the type of suspicious activity, the dollar amount involved, along with any loss to the financial institution, and information about the reporting financial institution. Part V of the SAR form requests a narrative description of the suspect violation and transactions and is used to document what supporting information and records the financial institution retains. This section is considered very critical in terms of explaining the apparent criminal activity to law

enforcement and regulatory agencies. The information provided in this section should be complete, accurate, and well-organized. This section should contain additional information on suspects, describe instruments and methods of facilitating the transaction, and provide any follow-up action taken by the financial institution. Data inserts in the form of tables or graphics are discouraged as they are not compatible with the SAR database at FinCEN. Also, attachments to a SAR form will not be stored in the database because they do not conform to the database format. Consequently, a narrative in Part V that states only "see attached" will result in no meaningful description of the transaction, rendering the record in this field insufficient.

The financial institution is also encouraged to detail a listing of documentation available that supports the SAR filing in Part V of the SAR form. This notice will provide law enforcement the awareness necessary to ensure timely access to vital information, if further investigation results from the SAR filing. All documentation supporting the SAR must be stored by the financial institution for five years and is considered property of the U.S. Government.

FinCEN has provided ongoing guidance on how to prepare SAR forms in its publication, "SAR Activity Reviews," under a section on helpful hints, tips, and suggestions on SAR filing. These publications are available at the FinCEN website. Financial institution management should be encouraged to review current and past issues as an aid in properly completing SARs.

SAR Filing Deadlines

By regulation, SAR forms are required to be filed no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. If no suspect was identified on the date of detection of the incident requiring the filing, a financial institution may delay filing a SAR for an additional 30 calendar days in order to identify a suspect. In no case shall reporting be delayed more than 60 days after the date of initial detection of a reportable transaction.

Customers Engaging in Ongoing Suspicious Activity

If a customer's suspicious activity continues to occur, FinCEN recommends the financial institution file an update on the activity and amounts every 90 days using the SAR form. In such instances, the financial institution should aggregate the dollar amount of previously reported activity and the dollar amount of the newer activity and put this amount in the box on the SAR requesting "total dollar amount involved in known or suspicious activity." Similarly, for the date range of suspicious activity, the financial institution should maintain the original "start" date and extend the "to" date to include the 90 day period in which the suspicious and reportable activity continued.

Failure to File SARs

If an examiner determines that a financial institution has failed to file a SAR when there is evidence to indicate a report should have been filed, the examiner should instruct the financial institution to immediately file the SAR. If the financial institution refuses, the examiner should complete the SAR and cite violations of Part 353 of the FDIC's Rules and Regulations, providing limited details of suspicious activity or the SAR in the Report of Examination. In instances involving a senior officer or director of the financial institution, examiners may prepare the SAR, rather than request the financial institution to do so in order to ensure that the SAR explains the suspicious activity accurately and completely. Each Regional Office is responsible for monitoring SARs filed within that region. Examiner-prepared SARs should be forwarded to their Regional Special Activities Case Manager to ensure timely and proper filing. Any examiner-prepared SARs and all supporting documents should be maintained in the field office files for five years.

SAR Filing Methods

SARs can be filed in paper form, by magnetic tape, or through the Patriot Act Communications System. Financial institutions may contact law enforcement and their Federal Banking Agency to notify them of the suspicious activity, and these contacts should be noted on the SAR form.

Notification to Board of Directors of SAR Filings

Section 353.3 of the FDIC's Rules and Regulations requires the financial institution's board of directors, or designated committee, be promptly notified of any SAR filed. However, if the subject of the SAR is a senior officer or member of the board of directors of the financial institution, notification to the board of directors should be handled differently in order to avoid violating Federal laws that prohibit notifying a suspect or person involved in the suspicious transaction that forms the basis of the SAR. In these situations, it is recommended that appropriate senior personnel not involved in the suspicious activity be advised of the SAR filing and this process be documented.

In cases of financial institutions that file a large volume of SARs, it is not necessary that the board of directors, or

designated committee thereof, review each and every SAR document. It is acceptable for the BSA officer to prepare an internal tracking report that briefly discusses all of the SARs filed for a particular month. As long as this tracking report is meaningful in content, then the institution will still be meeting the requirements of Part 353 of the FDIC's Rules and Regulations. Such a report would identify the following information for each SAR filed:

- Customer's name and any additional suspects;
- Social Security Number or TIN;
- Account number (if a customer);
- The date range of suspicious activity;
- The dollar amount of suspicious activity;
- Very brief synopsis of reported activity (for example, "cash deposit structuring" or "wire transfer activity inconsistent with business/occupation"); and
- Indication of whether it is a first-time filing or repeat filing on the customer/suspects.

Such a tracking report promotes efficiency in review of multiple SAR filings. Nevertheless, there are still some SARs that the board of directors, or designated committee thereof, should review individually. Such "significant SARs" would include those that involve insiders (notwithstanding the guidance above regarding the handling of SARs involving board members and senior management), suspicious activity above an internally determined dollar threshold, those involving significant check kiting activity, etc. Financial institutions are encouraged to develop their own parameters for defining "significant SARs" necessitating full reviews; such guidance needs to be written and formalized within board approved BSA policies and procedures.

Safe Harbor for Institutions on SAR Filings

A financial institution that files a SAR is accorded safe harbor from civil liability for filing reports of suspected or known criminal violations and suspicious activities with appropriate authorities. Any financial institution that is subpoenaed or otherwise requested to disclose information contained in a SAR or the fact that a SAR was filed to others shall decline to produce the SAR or provide any information or statements that would disclose that a SAR has been prepared or filed. This prohibition does not preclude disclosure of facts that are the basis of the SAR, as long as the disclosure does not state or imply that a SAR has been filed on the underlying information.

Recently, the safe harbor protections were reiterated and expanded. Section 351 of the USA PATRIOT Act, amended Section 5318(g)(3) of 31 USC and included directors, officers, employees, and agents of the financial institutions who participate in preparing and reporting of SARs under safe harbor protections. Section 355 of the USA PATRIOT Act, implemented at Section 18(w) of the FDI Act, established a means by which financial institutions can share factual information of suspected involvement in criminal activity with each other in connection with references for employment. To comply, employment references must be written and the disclosure made without malicious intent. The financial institution still may not disclose that a SAR was filed. The sharing of employment information is voluntary and should be done under adequate procedures, which may include review by the institution's legal counsel to assess potential for claims of malicious intent.

Examination Guidance

Examiners should ensure that the financial institution has procedures in place to identify and report suspicious activity for all of the financial institution's departments and activities. The guidance may be contained in several policies and procedures; however, it may be advisable for the financial institution to centrally manage the reporting of suspicious activities to ensure that transactions are being reported, when appropriate. A single point of contact can also expedite law enforcement contacts and requests to review specific SARs and their supporting documentation.

As part of its BSA and anti-money laundering programs, the financial institution's policies should detail procedures for complying with suspicious activity reporting requirements. These procedures should define reportable suspicious activity. Financial institutions are encouraged to elaborate and clarify definitions using examples and discussion of the criminal violations. Parameters to filter transactions and review for customer suspicious activity should also be established. Typically, the criteria will be used to identify exceptions to expected customer and transaction activity patterns and identify high-risk customers, whose accounts and transactions should be subject to enhanced scrutiny. Procedures to facilitate accurate and timely filing of SARs, as well as to ensure proper maintenance of supporting documentation, should also be prescribed. Procedures to document decisions not to file a SAR should also be established. Reporting requirements, including reporting SAR filings to senior management and institution directors should be defined. Any additional actions, such as closer monitoring or closing of an involved account(s) that the financial institution may wish to take should be defined in the policy. Many institutions are concerned about facilitating money laundering by continuing to process these suspicious transactions. As there is no requirement to close an account, the institution should assess each

situation and provide corresponding guidance on this area in its policy. If the financial institution does plan to close an account that is under investigation by law enforcement, then the institution should notify law enforcement of its intent to close the account.

SAR Database

If examiners need specific SAR filing information, they should contact their Regional SACM or other designees. These specially designated individuals have access to the FinCEN computer system and the database containing records of SAR filings. The database contains information from SARs filed by all federally insured financial institutions. The database is maintained according to the numbered reporting fields in the SAR form, so information can be searched, for example, by suspect, type of violation, or location.

Under current guidance, examiners should obtain a listing or copies of the SARs filed in the current and previous two years by a financial institution for pre-examination planning purposes. Additional searches may be requested as needed, such as to identify whether a SAR has been filed for suspicious activity discovered during the examination, or to obtain information about additional SAR filings on a particular suspect or group of transactions.

For additional guidance on obtaining SAR data, refer to the detailed instructions provided within the "Currency and Banking Retrieval System" discussion within the "Financial Crimes Enforcement Network Reporting and Recordkeeping Requirements" section of this chapter.

OFFICE OF FOREIGN ASSETS CONTROL

The Treasury's Office of Foreign Assets Control administers laws that impose economic and trade sanctions based on foreign policy and national security objectives. Sanctions have been established against various entities and individuals such as targeted foreign countries, terrorists, international narcotics traffickers, and those engaging in activities relating to the proliferation of weapons of mass destruction. Collectively, such individuals and companies are called Specially Designated Nationals (SDNs) and Blocked Persons.

OFAC acts under Presidential wartime and national emergency powers, in addition to authority granted by specific legislation. OFAC has powers to impose controls on transactions and to freeze foreign assets under U.S. jurisdiction. Sanctions can be specific to the interests of the U.S.; however, many sanctions are based on United Nations and other international mandates. Sanctions can include one or more of the following:

- Blocking of assets,
- Trade embargoes,
- Prohibition on unlicensed trade and/or financial transactions,
- Travel bans, and
- Other financial and commercial prohibitions.

A complete list of countries and other specially-designated targets that are currently subject to U.S. sanctions and a detailed description of each order can be found on the Treasury website.

OFAC Applicability

OFAC regulations apply to all U.S. persons and entities, including financial institutions. As such, all U.S. financial institutions, their branches and agencies, international banking facilities, and domestic and overseas branches, offices, and subsidiaries must comply with OFAC sanctions.

Blocking of Assets, Accounts, and Transactions

OFAC regulations require financial institutions to block accounts and other assets and prohibit unlicensed trade and financial transactions with specified countries. Assets and accounts must be blocked when that property is located in the U.S., or is held by, possessed by, or under the control of U.S. persons or entities. The definition of assets and property can include anything of direct, indirect, present, future, and contingent value. Since this definition is so broad, it can affect many types of products and services provided by financial institutions.

OFAC regulations also direct that prohibited accounts of and transactions with SDNs and Blocked Persons need to be blocked or rejected. Generally, U.S. financial institutions must block or freeze funds that are remitted by or on behalf of a blocked individual or entity, are remitted to or through a blocked entity, or are remitted in connection with a transaction in which a blocked entity has an interest. For example, a financial institution cannot send a wire transfer to a blocked entity; once a payment order has been received from a customer, those funds must be placed in an account on the blocked entity's behalf. The interest rate must be a commercially reasonable rate (i.e., at a rate currently offered to other depositors with similar deposit size and terms). Customers cannot cancel or amend payment orders on blocked funds after the U.S.

financial institution has received the order or the funds in question. Once these funds are blocked, they may be released only by specific authorization from the Treasury. Full guidelines for releasing blocked funds are available on the OFAC website. Essentially, either the financial institution or customer files an application with OFAC to obtain a license or authorization to release the blocked funds.

Rejected transactions are those that are to be stopped because the underlying action is prohibited and cannot be processed per the sanctions program. Rejected transactions are to be returned to the sending institution. Transactions include, but are not limited to, the following:

- Cash deposits;
- Personal, official, and traveler's checks;
- Drafts;
- Loans;
- Obligations;
- Letters of credit;
- Credit cards;
- Warehouse receipts;
- Bills of sale;
- Evidences of title;
- Negotiable instruments, such as money orders;
- Trade acceptances;
- Wire transfers;
- Contracts;
- Trust assets; and
- Investments.

OFAC Reporting Requirements

OFAC imposes reporting requirements for blocked property and blocked or rejected transactions. OFAC does not take control of blocked or rejected funds, but it does require financial institutions to report all blocked property to OFAC annually by September 30th. Additionally, financial institutions must notify OFAC of blocked or rejected transactions within 10 days of their occurrence.

When an institution identifies an entity that is an exact match, or has many similarities to a subject listed on the SDN and Blocked Persons List, the institution should contact OFAC Compliance at 1-800-540-6322 for verification. Unless a transaction involves an exact match, it is recommended that the institution contact OFAC Compliance before blocking assets.

Issuance of OFAC Lists

OFAC frequently publishes updates to its list of SDNs and Blocked Persons. This list identifies individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also includes those individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. OFAC adds and removes names as necessary and appropriate and posts those updates to its website. The Special Activities Section in Washington D.C. notifies FDIC-supervised institutions that updates to the SDN and Blocked Persons List are available through Financial Institution Letters.

Maintaining an updated SDN and Blocked Persons list is essential to an institution's compliance with OFAC regulations. It is important to remember that outstanding sanctions can and do change and names of individuals and entities are added to the list frequently. Financial institutions should establish procedures to ensure that its screening information is up-to-date to prevent accepting, processing, or facilitating illicit financial transactions and the potential civil liability that may result.

Financial Institution Responsibilities – OFAC Programs and Monitoring Systems

Financial institutions are subject to the prohibitions and reporting required by OFAC regulations; however, there are not any regulatory program requirements for compliance. Neither OFAC nor Federal financial institution regulators have established laws or regulations dictating what banking records must be screened for matches to the OFAC list, or how frequently reviews should be performed. A violation of law occurs only when the institution conducts a blocked or rejected transaction, regardless of whether the financial institution is aware of it. Additionally, institutions that fail to block and report a transfer (which is subsequently blocked by another bank) may be subject to adverse publicity, fines, and even criminal penalties.

OFAC has the authority to assess CMPs for any sanction violation, and these penalties can be severe. Over the past several years, OFAC has had to impose millions of dollars in CMPs involving U.S. financial institutions. The majority of these fines resulted from institution's failure to block illicit transfers when there was a reference to a targeted country or SDN. While the maximum penalties are established by law, OFAC will consider the Federal banking regulator's most recent assessment of the financial institution's OFAC compliance program as one of the mitigating factors for determining any penalty. In addition, OFAC can pursue criminal penalties if there is any evidence of criminal intent on the part of the financial

institution or its employees. Criminal penalties provide for imprisonment up to 30 years and fines ranging up to $10 million.

Furthermore, financial institutions are not permitted to transfer responsibility for OFAC compliance to correspondent banks or a contracted third party, such as a data processing service provider. Each financial institution is responsible for every transaction occurring by or through its systems. If a sanctioned transaction transverses several U.S. financial institutions, all of these institutions will be subject to the same civil or criminal action, with the exception of the financial institution that blocked or rejected the transaction, as appropriate.

Examination Considerations

Financial institutions should establish and maintain effective OFAC programs and screening capabilities in order to facilitate safe and sound banking practices. It is not the examiner's primary duty to identify unreported accounts or transactions within an institution. Rather, examination procedures should focus on evaluating the adequacy of an institution's overall OFAC compliance program and procedures, including the systems and controls in place to reasonably assure accounts and transactions are blocked and rejected.

In reviewing an institution's OFAC compliance program, examiners should evaluate the operational risks the financial institution is willing to accept and determine if this exposure is reasonable in comparison with the business type, department or product, customer base, and cost of an effective screening program for that particular institution, based on its risk profile.

The FDIC strongly recommends that each financial institution adopt a risk-focused, written OFAC program designed to ensure compliance with OFAC regulations. An effective OFAC program should include the following:

- Written policies and procedures for screening transactions and new customers to identify possible OFAC matches;
- Qualified individual to monitor compliance and oversee blocked funds;
- OFAC risk-assessment for various products and departments within the financial institution;
- Guidelines and internal controls to ensure the periodic screening of all existing customer accounts;
- Procedures for obtaining and maintaining up-to-date OFAC lists of blocked countries, entities, and individuals;
- Methods for conveying timely OFAC updates throughout the financial institution, including offshore locations and subsidiaries;
- Procedures for handling and reporting prohibited OFAC transactions;
- Guidance for SAR filings on OFAC matches, if appropriate, such as when criminal intent or terrorist activity is involved;
- Internal review or audit of the OFAC processes in each affected department; and
- Training for all appropriate employees, including those in offshore locations and subsidiaries.

Departmental and product risk assessments are fundamental to a sound OFAC compliance program. These assessments allow institution management to ensure appropriate focus on high-risk areas, such as correspondent banking activities and electronic funds transfers. An effective program will filter as many transactions as possible through OFAC's SDN and Blocked Persons List, whether they are completed manually or through the use of a third party software program. However, when evaluating an institution's compliance program, examiners should consider matters such as the size and complexity of the institution. Adequate compliance procedures can and should be targeted to transactions that pose the greatest risk to an institution. Some transactions may be difficult to capture within a risk-focused compliance program. For example, a customer could write a personal check to a blocked entity; however, the only way the financial institution that the check is drawn upon could block those funds would be if it reviewed the payee on each personal check, assuming the information is provided and legible. Under current banking practices, this would be costly and time consuming. Most financial institutions do not have procedures for interdicting these transactions, and, yet, if such a transaction were to be processed by a U.S. financial institution, it is a violation of OFAC regulations and could result in CMPs against the bank.

However, if a financial institution only screens its wire transfers through the OFAC SDN and Blocked Persons List and never screens its customer database, that is a much higher and, likely, unacceptable risk for the financial institution to assume in relation to the time and expense to perform such a review. Particular risk areas that should be screened by all financial institutions include:

- Incoming and outgoing electronic transactions, such as ACH;
- Funds transfers, including message or instruction fields;
- Monetary instrument sales; and

- Account beneficiaries, signors, powers of attorney, and beneficial owners.

As mentioned previously, account and transaction screening may be done manually, or by utilizing computer software available from the Treasury website or other third party vendors. In fact, many institutions have outsourced this function. If automated, OFAC offers the SDN list in a delimited file format file that can be imported into some software programs. Commercial vendors also offer several OFAC screening software packages with various capabilities and costs. If an institution utilizes an automated system to screen accounts and transactions, examiners should ensure that the institution's policies and procedures address the following:

- OFAC updates are timely;
- OFAC verification can be and is completed in a reasonable time;
- Screening is completed by all of bank departments and related organizations; and
- Process is reasonable in relation to the institution's risk profile.

Wholly-owned securities and insurance subsidiaries of financial institutions must also adopt an OFAC compliance program tailored to meet industry specific needs. The OFAC website provides additional reference material to these industries concerning compliance program content and procedures.

OFAC maintains current information and FAQs on its website. For any questions, OFAC encourages financial institutions to contact its Compliance Hotline at 800-540-6322 (7:30am-6:00pm, weekdays).

EXAMPLES OF PROPER CITATION OF APPARENT VIOLATIONS OF BSA-RELATED REGULATIONS IN THE REPORT OF EXAMINATION

The situations depicted in the examples below are intended to provide further clarification on when and how to cite apparent violations of the BSA and implementing regulations, within the context of findings that are typical for BSA reviews conducted during regular Safety & Soundness examinations. As is often the case, deficiencies identified within an institution's BSA compliance policies and procedures may lead to the citation of one or more apparent violations. The identification of numerous and/or severe deficiencies may indicate an ineffective and inadequate program. When an institution's BSA compliance program is considered inadequate, an apparent violation of Part 326.8(b)(1) of the FDIC's Rules and Regulations should also be cited.

Example 1

An examiner is conducting a BSA review at Urania Bank, a $100 million dollar financial institution in El Paso, Texas. The examiner identifies a systemic violation because the financial institution has not filed CTRs on cash purchases of monetary instruments. This is an apparent violation of 31 CFR 103.22(b)(1). The examiner also identifies a complete failure to scrub the institution's database against 314(a) Requests. This is an apparent violation of 31 CFR 103.100(b)(2). In addition, the examiner identifies numerous incomplete CTRs in apparent violation of 31 CFR 103.27(d). Because of the internal control inadequacies, the examiner also cites an apparent violation of Section 326.8(c)(1). The examiner further determines that the problems are sufficiently serious, warranting the citation of an apparent violation of Section 326.8(b)(1) for failure to develop and provide for an adequate BSA program. After doing additional research, the examiner determines that an apparent violation of Section 326.8(c)(2) should also be cited for inadequate independent testing that should have identified the ongoing weaknesses found by the examiner. Furthermore, the examiner decides that an apparent violation of Section 326.8(c)(4) should be cited for inadequate training. Employees are given cursory BSA training each year; however, no training exists for appropriate identification of cash activity and adequate CTR filings. The examiner also determines that an apparent violation of Section 326.8(c)(3) is appropriate because the BSA officer at Urania Bank comes in only two days per week. This is clearly inadequate for a financial institution of this size and complexity, as exhibited by the systemic BSA problems. In addition to fully addressing these deficiencies in the Violations and Risk Management sections of the Report of Examination, the Examiner-In-Charge fully details the findings, weaknesses, and management responses on the Examiner Comments and Conclusions pages.

Example 2

Examiners at Delirium Thrift, a $500 million financial institution in Southern California, begin the BSA review by requesting the wire transfer log for incoming and outgoing transactions. Information being obtained by the institution for the outgoing wire transfers is identified as inadequate. Consequently, the examiners cite an apparent violation of 31 CFR 103.33(g)(1). Additional research reveals that deficiencies in the wire log information are attributed to several branch locations that are failing to provide

sufficient information to the wire transfer department. Because the deficiencies are isolated to transactions originating in a few locations, examiners determine that the deficiencies are not systemic and the overall program remains effective. However, because it is evident in interviews with several branch employees that their training in this area has been lacking, examiners also cite an apparent violation of Section 326.8(c)(4) and request that the institution implement a comprehensive training program that encompasses all of its service locations.

Example 3

Examiners at the independent BSA examination of Bullwinkle Bank and Trust, Moose-Bow, Iowa, a $30 million financial institution, were provided no written BSA policies after several requests. However, actual internal practices for BSA compliance were found to be fully satisfactory for the size and BSA risk-level of the financial institution. Given the low risk profile of the institution, including a nominal volume of reportable transactions being processed by the institution, the BSA/AML procedures in place are sufficient for the institution. Therefore, examiners cite only an apparent violation of Section 326.8(b)(1) for failure to develop an adequate *written* BSA compliance program that is approved by the financial institution's board of directors.

Example 4

Appropriately following pre-examination scoping requirements, examiners obtain information from their Regional SACM or other designees on previous SAR filings relating to money laundering. Upon arrival at Mission Achievement Bank, Agana, Guam, a $250 million financial institution with overseas branches, examiners determine that several of the accounts upon which money laundering SARs had been previously filed are still open and evidencing ongoing money laundering activity. However, the financial institution has failed to file subsequent SARs on this continued activity in these accounts and/or the parties involved. Consequently, the examiner appropriately cites apparent violations of Section 353.3(a) of the FDIC Rules and Regulations for failure to file SARs on this ongoing activity. Further analysis identifies that the failure to appropriately monitor for suspicious or unusual transactions in its high-risk accounts and subsequently file SARs is a systemic problem at the financial institution. Because of the institution-wide problem, the examiner cites an apparent violation of Section 326.8(c)(1) for inadequate internal controls. Furthermore, after consultation with the Regional SACM, the examiner concludes that the institution's overall BSA program is inadequate because of the failures to identify and report suspicious activities and, therefore, cites an apparent violation of Section 326.8(b)(1).

The examples below provide examiner guidance for preparing written comments for apparent violations of the BSA and implementing regulations. In general, write-ups should fully detail the nature and severity of the infraction(s). These comments intentionally omit the management responses that should accompany all apparent violation write-ups.

Part 326.8(b)(1) of the FDIC Rules and Regulations

Part 326.8(b)(1) requires each bank to "develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements" of the Bank Secrecy Act, or 31 CFR 103. The regulation further states that "the compliance program shall be written, approved by the bank's board of directors, and noted in the minutes."

The Board and the senior management team have not adequately established and maintained appropriate procedures reasonably designed to assure and monitor the financial institution's compliance with the requirements of the BSA and related regulations. This assessment is evidenced by the weak internal controls, policies, and procedures as identified at this examination. Furthermore, the Board and senior management team have not made a reasonable effort to assure and monitor compliance with recordkeeping and reporting requirements of the BSA. As a result, apparent violations of other sections of Part 326.8 of the FDIC Rules and Regulations and 31 CFR 103 of the U.S. Treasury Recordkeeping Regulations have been cited.

Part 326.8(b)(2) of the FDIC Rules and Regulations

Part 326.8(b)(2) states that each bank must have a customer identification program to be implemented as part of the BSA compliance program.

Management has not provided for an adequate customer identification program. Current policy requirements do not meet the minimum provisions for a customer identification program, as detailed in 31 CFR 103. Current policies and practices require no documentation for new account openings on the Internet with the exception of a "verification e-mail" sent out confirming that the signer wants to open the account. Signature cards are mailed off-site to the Internet customer, who signs them and mails them back without any evidence of third-party verification, such as notary seal. Based on the risk of these types of accounts, this methodology for verification is clearly

inadequate to meet regulatory requirements and sound customer due diligence.

Part 326.8(c)(1) of the FDIC Rules and Regulations

Part 326.8(c)(1) states, in part, that the compliance program shall, at a minimum, provide for a system of internal controls to assure ongoing compliance.

Management has not provided for an adequate system of internal controls to assure ongoing compliance. Examiners identified the following internal control deficiencies:

- Incomplete BSA and AML policies for a bank with a high-risk profile.
- Insufficient identification systems for CTR reporting.
- Late CTR filings.
- Insufficient reporting mechanisms for identification of structured transactions and other suspicious activity.
- Weak oversight over high-risk customers.
- Insufficient customer identification program and customer due diligence.

Due to the financial institution's high-risk profile, management should go beyond minimum CIP requirements and do a sufficient level of due diligence that provides for a satisfactory evaluation of the customer. Management must provide for adequate reporting mechanisms to identify large cash transactions as well as suspicious activity. Timely completion and review of appropriate reports, in conjunction with a sufficient level of due diligence, should allow for the accurate and timely reporting of CTRs and SARs.

Part 326.8(c)(2) of the FDIC Rules and Regulations

Part 326.8(c)(2) states that the compliance program shall provide for independent testing for compliance to be conducted by an outside party or bank personnel who have no BSA responsibility or oversight.

The financial institution's BSA policies provide for independent testing. However, the financial institution has not received an independent review for over three years. An annual review of the BSA program should be completed by a qualified independent party. This review should incorporate all of the high-risk areas of the institution, including cash-intensive accounts and transactions, sales and purchases of monetary instruments; customer exemption list; electronic funds transfer activities, and compliance with customer identification procedures.

Part 326.8(c)(3) of the FDIC Rules and Regulations

Part 326.8(c)(3) states that the compliance program shall designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance.

The board of directors has named Head Teller Ben Bison as the BSA officer. While Mr. Bison has a basic understanding of CTR filing, he does not have any training on detecting and reporting suspicious activity. Furthermore, Ben Bison does not have policy-making authority over the BSA function. Management needs to appoint someone with policy-making authority as the institution's BSA Officer.

Part 326.8(c)(4) of the FDIC Rules and Regulations

Part 326.8(c)(4) states that the compliance program shall provide training for appropriate personnel.

Example 1:

While BSA training programs are adequate, management has trained less than half of the appropriate operational personnel during the last calendar year. Management must ensure that all appropriate personnel, including the board of directors and officers, receive adequate BSA training a minimum of once per year and ongoing for those whose duties require constant awareness of the BSA requirements.

Example 2:

BSA training needs improvement. While regular BSA training sessions are developed and conducted for branch operations personnel, the training programs do not address internal BSA policies and, more importantly, BSA and anti-money laundering regulations. Management must ensure that comprehensive BSA training is provided to all directors, officers, and appropriate operational personnel. Training should be provided at least annually, and must be ongoing for those whose duties require constant awareness of BSA requirements. The training must be commensurate with the institution's BSA risk-profile and provide specific employee guidance on detecting unusual or suspicious transactions beyond the detection of cash structuring transactions.

Part 353.3 of the FDIC Rules and Regulations and 31 C.F.R. 103.18

Part 353.3(a) and 31 C.F.R. 103.18 state, in part, that Suspicious Activity Reports (SARs) should be filed when:

- Insider abuse is involved in any amount;

- Transactions aggregating $5,000 or more when the suspect can be identified;
- Transactions aggregating $25,000 or more when the suspect can not be identified; and
- Transactions aggregating $5,000 or more that involve money laundering or violations of the BSA… if the bank knows, suspects, or has reason to suspect that:
    - The transaction involves funds derived from illegal activities,
    - The transaction is designed to evade BSA reporting requirements, or
    - The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Management failed to file SARs on several different deposit account customers, all of which appeared to be structuring cash deposits to avoid the filing of CTRs. These transactions all appeared on large cash transaction reports reviewed by management; however, no one in the institution researched the transactions or filed SARs on the incidents. Management must file SARs on the following customer transactions and appropriately review suspicious activity and file necessary SARs going forward.

Account Number	Dates	Total Cash Deposited
123333	02/20/xx-02/28/xx	$50,000
134445	03/02/xx-03/15/xx	$32,300
448832	01/05/xx-03/10/xx	$163,500
878877	03/10/xx-03/27/xx	$201,000

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3)

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3) state that a bank shall file a suspicious activity report (SAR) no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. In no case shall reporting be delayed more than 60 calendar days after the date of initial detection.

Management and the board have failed to file several hundred SARs within 30 calendar days of the initial detection of the suspicious activity. The BSA officer failed to file any SARs for the time period of June through August 20XX. This information was verified through use of the FinCEN database, which showed than no SARs had been filed during that time period. In addition, SARs filed from February through May of 20XX were filed between 65 days and 82 days of the initial detection of the activity. Management must ensure that suspicious activity reports are not only identified, but also filed in a timely manner.

Part 353.3(f) of the FDIC Rules and Regulations

Part 353.3(f) of the FDIC Rules and Regulations states that bank management must promptly notify its board of directors, or a committee thereof, of any report filed pursuant to Part 353 (Suspicious Activity Reports).

Management has not properly informed the board of directors of SARs filed to report suspicious activities. The management team has provided the board with erroneous reports showing that the bank has filed SARs, when, in fact, the management team never did file such SARs. Board and committee minutes clearly indicate a reliance on these reports as accurate.

31 C.F.R. 103.22(c)(2)

This section of the Financial Recordkeeping Regulations requires the bank to treat multiple transactions totaling over $10,000 as a single transaction.

Management's large cash aggregation reports include only those cash transactions above $9,000. Because of this weakness in the reporting system's set-up, the report failed to pick up transactions below $9,000 from multiple accounts with one owner. The following transactions were identified which should have been aggregated and a CTR filed. Management needs to alter or improve their system in order to identify such transactions.

Customer Name Account #	Date	Amount
Mini Meat Market		
122222222	12/12/xx	$8,000
122233333	12/12/xx	$4,000
122222222	12/16/xx	$6,000
122233333	12/16/xx	$5,000
Claire's Club Sandwiches a/k/a Claire's Catering		
15555555	12/22/xx	$4,000
17777777	12/22/xx	$7,000
17777788	12/22/xx	$3,000

31 C.F.R. 103.22(d)(6)(i)

This section of the Financial Recordkeeping regulation states that a bank must document monitoring of exempt

person transactions. Management must review exempt accounts at least one time per year and must document appropriate monitoring and review of each exempt account.

Management has exempted three customers, but has failed to document monitoring of their accounts. Management has stated that they did monitor the account transactions and no suspicious activity appears evident; however, management must retain appropriate documentation for all account monitoring of exempt customers. Such monitoring documentation could include, but is not limited to:

- Reviews of exempt customers cash transactions,
- Review of monthly statements and monthly activity,
- Interview notes with account owners or visitation notes from reviewing the place of business,
- Documenting changes of ownership, or
- Documenting changes in amount, timing, or type of transaction activity.

31 C.F.R. 103.27(a)

This section of the Financial Recordkeeping regulation requires the financial institution to retain all Currency Transaction Reports for five years.

Management failed to keep copies of all of the CTRs filed during the past five years. Management can locate CTRs filed for the past two years but has not consistently retained CTR copies for the three years preceding. Management needs to make sure that its record-keeping systems allow for the retention and retrieval of all CTRs filed for the previous five year time period.

31 C.F.R. 103.27(d)

This section of the Financial Recordkeeping regulation requires the financial institution to include all appropriate information required in the CTR.

Management has consistently failed to obtain information on the individual conducting the transaction unless that person is also the account owner. This information is required in the CTR and must be completed. Since this is a systemic failure, management needs to ensure proper training is provided to tellers and other key employees to ensure that this problem is corrected.

31 C.F.R. 103.121(b)(2)(i)(A)(4)(ii)

This section of the Financial Recordkeeping regulation states that the financial institution must obtain a tax identification number or number and country of issuance of any government-issued documentation.

The financial institution's policies and programs require that all employees obtain minimum customer identification information; however, accounts in the Vermont Street Branch have not been following minimum account opening standards. Over half of the accounts opened at the Vermont Street Branch since October 1, 2003, when this regulation came into effect, have been opened without tax identification numbers or similar personal identification number for non-U.S. citizens. Management must ensure that BSA policies and regulations are followed throughout the institution and verify through BSA officer reviews and independent reviews that requirements are being met.

WEB-SITE REFERENCES

Financial Crimes Enforcement Network (FinCEN): www.fincen.gov

FinCEN Money Services Businesses: www.msb.gov

Financial Action Task Force: www.oecd.org/fatf

Office of Foreign Assets Control: www.ustreas.gov/offices/eotffc/ofac

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List of Resources for Marijuana Businesses and Attorneys*

1. **Medical Marijuana Constitutional Amendment:** Article XVIII Section 14
2. **Retail Marijuana Constitutional Amendment:** Article XVIII Section 16
3. **Colorado Medical Marijuana Statutes:** C.R.S. 12-43.3-101 et. seq.
4. **Colorado Retail Marijuana Statutes:** C.R.S. 12-43.4-101 et. seq.
5. **Statute: Contracts pertaining to marijuana enforceable** C.R.S. 13-22-601.
6. **MED Medical Rules:** https://www.colorado.gov/pacific/sites/default/files/1CCR212-1_Medical.pdf
7. **MED Retail Rules:** https://www.colorado.gov/pacific/sites/default/files/1CCR212-1_Retail.pdf
8. **Index of local codes:** https://www.municode.com/library/co
9. **MED Website:** https://www.colorado.gov/pacific/enforcement/marijuanaenforcement
10. **State MJ Licensing Applications:** https://www.colorado.gov/pacific/enforcement/med-application-and-licensing
11. **Denver Licensing:** https://www.denvergov.org/content/denvergov/en/denver-business-licensing-center/marijuana-licenses/retail-marijuana.html
12. **City of Boulder Licensing:** https://bouldercolorado.gov/tax-license/recreational-marijuana-businesses
13. **Boulder County Licensing:** http://www.bouldercounty.org/records/licenses/pages/mmj.aspx
14. **Pueblo County Licensing:** http://county.pueblo.org/government/county/department/planning-and-development/planning-and-development/marijuana
15. **Denver Post Marijuana News (Cannabist):** http://www.thecannabist.co/
16. **Marijuana law information:** http://www.marijuanalawscolorado.com

*Links compiled 11/1/2017. It is important to double check that all rules and applications are current.

Committee struck them all out, substituting only a provision dealing with a credit for contractual prohibitions against the payment of dividends.[10] An amendment offered from the Senate floor, giving a broad credit for all portions of adjusted net income used to purchase or replace machinery, equipment, etc., or "expended or applied during the taxable year for the liquidation, payment, or reduction of the principal of any bona-fide indebtedness outstanding at the date of enactment of this Act," was rejected.[11] The much narrower amendment which became § 26 (c) (2) was then offered, with little explanation other than that it was intended to supplement the credit for contractual prohibition against dividend payments, the provision which became § 26 (c) (1).[12]

We conclude that the judgments below were erroneous. Accordingly they are reversed, and the causes remanded with directions to uphold the determination of the Commissioner.

Reversed.

WICKARD, SECRETARY OF AGRICULTURE, ET AL. *v.* FILBURN.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF OHIO.

No. 59. Argued May 4, 1942. Reargued October 13, 1942.—Decided November 9, 1942.

1. Pending a referendum vote of farmers upon wheat quotas proclaimed by the Secretary of Agriculture under the Agricultural Adjustment Act of 1938, the Secretary made a radio address in which he advocated approval of the quotas and called attention to the recent enactment by Congress of the amendatory act, later approved

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[10] This legislative history is discussed in *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 50.

[11] 80 Cong. Rec. 9055, 9070, 74th Cong., 2d Sess.

[12] 80 Cong. Rec. 9071, 74th Cong., 2d Sess.

May 26, 1941. The speech mentioned the provisions of the amendment for increase of loans on wheat but not the fact that it also increased the penalty on excess production, and added that because of the uncertain world situation extra acreages of wheat had been deliberately planted and "farmers should not be penalized because they have provided insurance against shortages of food." There was no evidence that the subsequent referendum vote approving the quotas was influenced by the speech. *Held,* that, in any event and even assuming that the penalties referred to in the speech were those prescribed by the Act, the validity of the vote was not thereby affected. P. 117.

2. The wheat marketing quota and attendant penalty provisions of the Agricultural Adjustment Act of 1938, as amended by the Act of May 26, 1941, when applied to wheat not intended in any part for commerce but wholly for consumption on the farm are within the commerce power of Congress. P. 118.
3. The effect of the Act is to restrict the amount of wheat which may be produced for market and the extent as well to which one may forestall resort to the market by producing for his own needs. P. 127.
4. That the production of wheat for consumption on the farm may be trivial in the particular case is not enough to remove the grower from the scope of federal regulation, where his contribution, taken with that of many others similarly situated, is far from trivial. P. 127.
5. The power to regulate interstate commerce includes the power to regulate the prices at which commodities in that commerce are dealt in and practices affecting such prices. P. 128.
6. A factor of such volume and variability as wheat grown for home consumption would have a substantial influence on price conditions on the wheat market, both because such wheat, with rising prices, may flow into the market and check price increases and, because, though never marketed, it supplies the need of the grower which would otherwise be satisfied by his purchases in the open market. P. 128.
7. The amendatory Act of May 26, 1941, which increased the penalty upon "farm marketing excess" and included in that category wheat which previously had not been subject to penalty, *held* not invalid as retroactive legislation repugnant to the Fifth Amendment when applied to wheat planted and growing before it was enacted but harvested and threshed thereafter. P. 131.

43 F. Supp. 1017, reversed.

APPEAL from a decree of the District Court of three judges which permanently enjoined the Secretary of Agriculture and other appellants from enforcing certain penalties against the appellee, a farmer, under the Agricultural Adjustment Act.

Solicitor General Fahy, with whom *Assistant Attorney General Arnold* and *Messrs. Robert L. Stern, John S. L. Yost, W. Carroll Hunter,* and *Robert H. Shields* were on the briefs, on the original argument and on the reargument (*Mr. James C. Wilson* was also on the brief on the original argument), for appellants.

Messrs. Webb R. Clark and *Harry N. Routzohn,* with whom *Mr. Robert S. Nevin* was on the briefs, for appellee.

Messrs. William Lemke, Louis M. Day, and *T. A. Billingsly* filed a brief, as *amici curiae,* in support of appellee.

MR. JUSTICE JACKSON delivered the opinion of the Court.

The appellee filed his complaint against the Secretary of Agriculture of the United States, three members of the County Agricultural Conservation Committee for Montgomery County, Ohio, and a member of the State Agricultural Conservation Committee for Ohio. He sought to enjoin enforcement against himself of the marketing penalty imposed by the amendment of May 26, 1941,[1] to the Agricultural Adjustment Act of 1938,[2] upon that part of his 1941 wheat crop which was available for marketing in excess of the marketing quota established for his farm. He also sought a declaratory judgment that the wheat marketing quota provisions of the Act as amended and applicable to him were unconstitutional because not sus-

[1] 55 Stat. 203, 7 U. S. C. (Supp. No. I) § 1340.

[2] 52 Stat. 31, as amended, 7 U. S. C. § 1281 *et seq.*

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tainable under the Commerce Clause or consistent with the Due Process Clause of the Fifth Amendment.

The Secretary moved to dismiss the action against him for improper venue, but later waived his objection and filed an answer. The other appellants moved to dismiss on the ground that they had no power or authority to enforce the wheat marketing quota provisions of the Act, and after their motion was denied they answered, reserving exceptions to the ruling on their motion to dismiss.[8] The case was submitted for decision on the pleadings and upon a stipulation of facts.

The appellee for many years past has owned and operated a small farm in Montgomery County, Ohio, maintaining a herd of dairy cattle, selling milk, raising poultry, and selling poultry and eggs. It has been his practice to raise a small acreage of winter wheat, sown in the Fall and harvested in the following July; to sell a portion of the crop; to feed part to poultry and livestock on the farm, some of which is sold; to use some in making flour for home consumption; and to keep the rest for the following seeding. The intended disposition of the crop here involved has not been expressly stated.

In July of 1940, pursuant to the Agricultural Adjustment Act of 1938, as then amended, there were established for the appellee's 1941 crop a wheat acreage allotment of 11.1 acres and a normal yield of 20.1 bushels of wheat an acre. He was given notice of such allotment in July of 1940, before the Fall planting of his 1941 crop of wheat, and again in July of 1941, before it was harvested. He sowed, however, 23 acres, and harvested from his 11.9 acres of excess acreage 239 bushels, which under the terms of the Act as amended on May 26, 1941, constituted farm

[8] Because of the conclusion reached as to the merits, we need not consider the question whether these appellants would be proper if our decision were otherwise.

marketing excess, subject to a penalty of 49 cents a bushel, or $117.11 in all. The appellee has not paid the penalty and he has not postponed or avoided it by storing the excess under regulations of the Secretary of Agriculture, or by delivering it up to the Secretary. The Committee, therefore, refused him a marketing card, which was, under the terms of Regulations promulgated by the Secretary, necessary to protect a buyer from liability to the penalty and upon its protecting lien.[4]

The general scheme of the Agricultural Adjustment Act of 1938 as related to wheat is to control the volume moving in interstate and foreign commerce in order to avoid surpluses and shortages and the consequent abnormally low or high wheat prices and obstructions to commerce.[5] Within prescribed limits and by prescribed standards the Secretary of Agriculture is directed to ascertain and proclaim each year a national acreage allotment for the next crop of wheat, which is then apportioned to the states and their counties, and is eventually broken up into allotments for individual farms.[6] Loans and payments to wheat farmers are authorized in stated circumstances.[7]

The Act further provides that whenever it appears that the total supply of wheat as of the beginning of any marketing year, beginning July 1, will exceed a normal year's domestic consumption and export by more than 35 per cent, the Secretary shall so proclaim not later than May 15 prior to the beginning of such marketing year; and that during the marketing year a compulsory national marketing quota shall be in effect with respect to the marketing

[4] Wheat—507, §§ 728.240, 728.248, 6 Federal Register 2695, 2699–2701.

[5] § 331, 7 U. S. C. § 1331.

[6] § 335, 7 U. S. C. § 1335.

[7] §§ 302 (b) (h), 303, 7 U. S. C. §§ 1302 (b) (h), 1303; § 10 of the amendment of May 26, 1941, 7 U. S. C. (Supp. I), § 1340 (10).

of wheat.[8] Between the issuance of the proclamation and June 10, the Secretary must, however, conduct a referendum of farmers who will be subject to the quota, to determine whether they favor or oppose it; and, if more than one-third of the farmers voting in the referendum do oppose, the Secretary must, prior to the effective date of the quota, by proclamation suspend its operation.[9]

On May 19, 1941, the Secretary of Agriculture made a radio address to the wheat farmers of the United States in which he advocated approval of the quotas and called attention to the pendency of the amendment of May 26, 1941, which had at the time been sent by Congress to the White House, and pointed out its provision for an increase in the loans on wheat to 85 per cent of parity. He made no mention of the fact that it also increased the penalty from 15 cents a bushel to one-half of the parity loan rate of about 98 cents, but stated that "Because of the uncertain world situation, we deliberately planted several million extra acres of wheat. . . . Farmers should not be penalized because they have provided insurance against shortages of food."

Pursuant to the Act, the referendum of wheat growers was held on May 31, 1941. According to the required published statement of the Secretary of Agriculture, 81 per cent of those voting favored the marketing quota, with 19 per cent opposed.

The court below held, with one judge dissenting, that the speech of the Secretary invalidated the referendum; and that the amendment of May 26, 1941, "in so far as it increased the penalty for the farm marketing excess over the fifteen cents per bushel prevailing at the time of planting and subjected the entire crop to a lien for the payment thereof," should not be applied to the appellee because

[8] § 335 (a), 7 U. S. C. § 1335 (a).

[9] § 336, 7 U. S. C. § 1336.

as so applied it was retroactive and in violation of the Fifth Amendment; and, alternatively, because the equities of the case so required. 43 F. Supp. 1017. Its judgment permanently enjoined appellants from collecting a marketing penalty of more than 15 cents a bushel on the farm marketing excess of appellee's 1941 wheat crop, from subjecting appellee's entire 1941 crop to a lien for the payment of the penalty, and from collecting a 15-cent penalty except in accordance with the provisions of § 339 of the Act as that section stood prior to the amendment of May 26, 1941.[10] The Secretary and his co-defendants have appealed.[11]

I

The holding of the court below that the Secretary's speech invalidated the referendum is manifest error. Read as a whole and in the context of world events that constituted his principal theme, the penalties of which he spoke were more likely those in the form of ruinously low prices resulting from the excess supply rather than the penalties prescribed in the Act. But under any interpretation the speech cannot be given the effect of invalidating the referendum. There is no evidence that any voter put upon the Secretary's words the interpretation that impressed the court below or was in any way misled. There is no showing that the speech influenced the outcome of the referendum. The record in fact does not show that any, and does not suggest a basis for even a guess as to how many, of the voting farmers dropped work to listen to "Wheat Farmers and the Battle for

[10] 7 U. S. C. § 1339. This imposed a penalty of 15¢ per bushel upon wheat marketed in excess of the farm marketing quota while such quota was in effect. See also, amendments of July 26, 1939, 53 Stat. 1126, 7 U. S. C. § 1335 (c), and of July 2, 1940, 54 Stat. 727, 7 U. S. C. § 1301 (b) (6) (A), (B).

[11] 50 Stat. 752–753, § 3, 28 U. S. C. § 380a.

Democracy" at 11:30 in the morning of May 19th, which was a busy hour in one of the busiest of seasons. If this discourse intended reference to this legislation at all, it was of course a public Act, whose terms were readily available, and the speech did not purport to be an exposition of its provisions.

To hold that a speech by a Cabinet officer, which failed to meet judicial ideals of clarity, precision, and exhaustiveness, may defeat a policy embodied in an Act of Congress, would invest communication between administrators and the people with perils heretofore unsuspected. Moreover, we should have to conclude that such an officer is able to do by accident what he has no power to do by design. Appellee's complaint, in so far as it is based on this speech, is frivolous, and the injunction, in so far as it rests on this ground, is unwarranted. *United States* v. *Rock Royal Co-operative*, 307 U. S. 533.

II

It is urged that under the Commerce Clause of the Constitution, Article I, § 8, clause 3, Congress does not possess the power it has in this instance sought to exercise. The question would merit little consideration since our decision in *United States* v. *Darby*, 312 U. S. 100,[12] sustaining the federal power to regulate production of goods for commerce, except for the fact that this Act extends federal regulation to production not intended in any part for commerce but wholly for consumption on the farm. The Act includes a definition of "market" and its derivatives, so that as related to wheat, in addition to its conventional meaning, it also means to dispose of "by feeding (in any

[12] See also, *Gray* v. *Powell*, 314 U. S. 402; *United States* v. *Wrightwood Dairy Co.*, 315 U. S. 110; *Cloverleaf Co.* v. *Patterson*, 315 U. S. 148; *Kirschbaum Co.* v. *Walling*, 316 U. S. 517; *Overnight Transportation Co.* v. *Missel*, 316 U. S. 572.

form) to poultry or livestock which, or the products of which, are sold, bartered, or exchanged, or to be so disposed of." [13] Hence, marketing quotas not only embrace all that may be sold without penalty but also what may be consumed on the premises. Wheat produced on excess acreage is designated as "available for marketing" as so defined, and the penalty is imposed thereon.[14] Penalties do not depend upon whether any part of the wheat, either within or without the quota, is sold or intended to be sold. The sum of this is that the Federal Government fixes a quota including all that the farmer may harvest for sale or for his own farm needs, and declares that wheat produced on excess acreage may neither be disposed of nor used except upon payment of the penalty, or except it is stored as required by the Act or delivered to the Secretary of Agriculture.

Appellee says that this is a regulation of production and consumption of wheat. Such activities are, he urges, beyond the reach of Congressional power under the Commerce Clause, since they are local in character, and their effects upon interstate commerce are at most "indirect." In answer the Government argues that the statute regulates neither production nor consumption, but only marketing; and, in the alternative, that if the Act does go beyond the regulation of marketing it is sustainable as a "necessary and proper" [15] implementation of the power of Congress over interstate commerce.

The Government's concern lest the Act be held to be a regulation of production or consumption, rather than of marketing, is attributable to a few dicta and decisions of this Court which might be understood to lay it down that activities such as "production," "manufacturing," and

[13] 54 Stat. 727, 7 U. S. C. § 1301 (b) (6) (A), (B).

[14] §§ 1, 2, of the amendment of May 26, 1941; Wheat—507, § 728.251, 6 Federal Register 2695, 2701.

[15] Constitution, Article I, § 8, cl. 18.

"mining" are strictly "local" and, except in special circumstances which are not present here, cannot be regulated under the commerce power because their effects upon interstate commerce are, as matter of law, only "indirect." [16] Even today, when this power has been held to have great latitude, there is no decision of this Court that such activities may be regulated where no part of the product is intended for interstate commerce or intermingled with the subjects thereof. We believe that a review of the course of decision under the Commerce Clause will make plain, however, that questions of the power of Congress are not to be decided by reference to any formula which would give controlling force to nomenclature such as "production" and "indirect" and foreclose consideration of the actual effects of the activity in question upon interstate commerce.

At the beginning Chief Justice Marshall described the federal commerce power with a breadth never yet exceeded. *Gibbons* v. *Ogden,* 9 Wheat. 1, 194–195. He made emphatic the embracing and penetrating nature of this power by warning that effective restraints on its exercise must proceed from political rather than from judicial processes. *Id.* at 197.

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[16] After discussing and affirming the cases stating that such activities were "local," and could be regulated under the Commerce Clause only if by virtue of special circumstances their effects upon interstate commerce were "direct," the opinion of the Court in *Carter* v. *Carter Coal Co.,* 298 U. S. 238, 308, stated that: "The distinction between a direct and an indirect effect turns, not upon the magnitude of either the cause or the effect, but entirely upon the manner in which the effect has been brought about. . . . the matter of degree has no bearing upon the question here, since that question is not—What is the *extent* of the local activity or condition, or the *extent* of the effect produced upon interstate commerce? but—What is the *relation* between the activity or condition and the effect?" See also, cases cited *infra,* notes 17 and 21.

For nearly a century, however, decisions of this Court under the Commerce Clause dealt rarely with questions of what Congress might do in the exercise of its granted power under the Clause, and almost entirely with the permissibility of state activity which it was claimed discriminated against or burdened interstate commerce. During this period there was perhaps little occasion for the affirmative exercise of the commerce power, and the influence of the Clause on American life and law was a negative one, resulting almost wholly from its operation as a restraint upon the powers of the states. In discussion and decision the point of reference, instead of being what was "necessary and proper" to the exercise by Congress of its granted power, was often some concept of sovereignty thought to be implicit in the status of statehood. Certain activities such as "production," "manufacturing," and "mining" were occasionally said to be within the province of state governments and beyond the power of Congress under the Commerce Clause.[17]

It was not until 1887, with the enactment of the Interstate Commerce Act,[18] that the interstate commerce power began to exert positive influence in American law and life. This first important federal resort to the commerce power was followed in 1890 by the Sherman Anti-Trust Act[19] and, thereafter, mainly after 1903, by many others. These statutes ushered in new phases of adjudication, which required the Court to approach the interpretation of the Commerce Clause in the light of an actual exercise by Congress of its power thereunder.

When it first dealt with this new legislation, the Court adhered to its earlier pronouncements, and allowed but

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[17] *Veazie* v. *Moor*, 14 How. 568, 573–574; *Kidd* v. *Pearson*, 128 U. S. 1, 20–22.

[18] 24 Stat. 379, 49 U. S. C. § 1, *et seq.*

[19] 26 Stat. 209, 15 U. S. C. § 1, *et seq.*

little scope to the power of Congress. *United States* v. *Knight Co.*, 156 U. S. 1.[20] These earlier pronouncements also played an important part in several of the five cases in which this Court later held that Acts of Congress under the Commerce Clause were in excess of its power.[21]

Even while important opinions in this line of restrictive authority were being written, however, other cases called forth broader interpretations of the Commerce Clause destined to supersede the earlier ones, and to bring about a return to the principles first enunciated by Chief Justice Marshall in *Gibbons* v. *Ogden, supra.*

Not long after the decision of *United States* v. *Knight Co., supra,* Mr. Justice Holmes, in sustaining the exercise of national power over intrastate activity, stated for the Court that "commerce among the States is not a technical legal conception, but a practical one, drawn from the course of business." *Swift & Co.* v. *United States,* 196 U. S. 375, 398. It was soon demonstrated that the effects of many kinds of intrastate activity upon interstate commerce were such as to make them a proper subject of federal regulation.[22] In some cases sustaining the exercise of federal power over intrastate matters the term "direct"

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[20] See also, *Hopkins* v. *United States,* 171 U. S. 578; *Anderson* v. *United States,* 171 U. S. 604.

[21] *Employers' Liability Cases,* 207 U. S. 463; *Hammer* v. *Dagenhart,* 247 U. S. 251; *Railroad Retirement Board* v. *Alton R. Co.,* 295 U. S. 330; *Schechter Corp.* v. *United States,* 295 U. S. 495; *Carter* v. *Carter Coal Co.,* 298 U. S. 238; cf. *United States* v. *Dewitt,* 9 Wall. 41; *Trade-Mark Cases,* 100 U. S. 82; *Hill* v. *Wallace,* 259 U. S. 44; *Heisler* v. *Thomas Colliery Co.,* 260 U. S. 245, 259–260; *Oliver Iron Co.* v. *Lord,* 262 U. S. 172, 178–179; *Utah Power & Light Co.* v. *Pfost,* 286 U. S. 165.

[22] *Northern Securities Co.* v. *United States,* 193 U. S. 197; *Swift & Co.* v. *United States, supra; Loewe* v. *Lawlor,* 208 U. S. 274; *Baltimore & Ohio R. Co.* v. *Interstate Commerce Commission,* 221 U. S. 612; *Southern Ry. Co.* v. *United States,* 222 U. S. 20; *Second Employers' Liability Cases,* 223 U. S. 1; *United States* v. *Patten,* 226 U. S. 525.

was used for the purpose of stating, rather than of reaching, a result; [23] in others it was treated as synonymous with "substantial" or "material"; [24] and in others it was not used at all.[25] Of late its use has been abandoned in cases dealing with questions of federal power under the Commerce Clause.

In the *Shreveport Rate Cases*, 234 U. S. 342, the Court held that railroad rates of an admittedly intrastate character and fixed by authority of the state might, nevertheless, be revised by the Federal Government because of the economic effects which they had upon interstate commerce. The opinion of Mr. Justice Hughes found federal intervention constitutionally authorized because of "matters having such a close and substantial relation to interstate traffic that the control is essential or appropriate to the security of that traffic, to the efficiency of the interstate service, and to the maintenance of conditions under which interstate commerce may be conducted upon fair terms and without molestation or hindrance." *Id.* at 351.

The Court's recognition of the relevance of the economic effects in the application of the Commerce Clause, ex-

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[23] *United Leather Workers* v. *Herkert Co.*, 265 U. S. 457, 471; cf. *Apex Hosiery Co.* v. *Leader*, 310 U. S. 469, 511; *Di Santo* v. *Pennsylvania*, 273 U. S. 34, 44 (dissent); *Northern Securities Co.* v. *United States*, 193 U. S. 197, 395; *Standard Oil Co.* v. *United States*, 221 U. S. 1, 66–69.

[24] In *Santa Cruz Co.* v. *Labor Board*, 303 U. S. 453, 466–467, Chief Justice Hughes said: " 'direct' has been contrasted with 'indirect,' and what is 'remote' or 'distant' with what is 'close and substantial.' Whatever terminology is used, the criterion is necessarily one of degree and must be so defined. This does not satisfy those who seek for mathematical or rigid formulas. But such formulas are not provided by the great concepts of the Constitution such as 'interstate commerce,' 'due process,' 'equal protection.' "

[25] *Baltimore & Ohio R. Co.* v. *Interstate Commerce Commission*, 221 U. S. 612; *Second Employers' Liability Cases*, 223 U. S. 1; *Interstate Commerce Commission* v. *Goodrich Transit Co.*, 224 U. S. 194.

emplified by this statement, has made the mechanical application of legal formulas no longer feasible. Once an economic measure of the reach of the power granted to Congress in the Commerce Clause is accepted, questions of federal power cannot be decided simply by finding the activity in question to be "production," nor can consideration of its economic effects be foreclosed by calling them "indirect." The present Chief Justice has said in summary of the present state of the law: "The commerce power is not confined in its exercise to the regulation of commerce among the states. It extends to those activities intrastate which so affect interstate commerce, or the exertion of the power of Congress over it, as to make regulation of them appropriate means to the attainment of a legitimate end, the effective execution of the granted power to regulate interstate commerce. . . . The power of Congress over interstate commerce is plenary and complete in itself, may be exercised to its utmost extent, and acknowledges no limitations other than are prescribed in the Constitution. . . . It follows that no form of state activity can constitutionally thwart the regulatory power granted by the commerce clause to Congress. Hence the reach of that power extends to those intrastate activities which in a substantial way interfere with or obstruct the exercise of the granted power." *United States* v. *Wrightwood Dairy Co.*, 315 U. S. 110, 119.

Whether the subject of the regulation in question was "production," "consumption," or "marketing" is, therefore, not material for purposes of deciding the question of federal power before us. That an activity is of local character may help in a doubtful case to determine whether Congress intended to reach it.[26] The same consideration might help in determining whether in the absence of Congressional action it would be permissible for the state

[26] Cf. *Federal Trade Commission* v. *Bunte Bros.*, 312 U. S. 349.

to exert its power on the subject matter, even though in so doing it to some degree affected interstate commerce. But even if appellee's activity be local and though it may not be regarded as commerce, it may still, whatever its nature, be reached by Congress if it exerts a substantial economic effect on interstate commerce, and this irrespective of whether such effect is what might at some earlier time have been defined as "direct" or "indirect."

The parties have stipulated a summary of the economics of the wheat industry. Commerce among the states in wheat is large and important. Although wheat is raised in every state but one, production in most states is not equal to consumption. Sixteen states on average have had a surplus of wheat above their own requirements for feed, seed, and food. Thirty-two states and the District of Columbia, where production has been below consumption, have looked to these surplus-producing states for their supply as well as for wheat for export and carry-over.

The wheat industry has been a problem industry for some years. Largely as a result of increased foreign production and import restrictions, annual exports of wheat and flour from the United States during the ten-year period ending in 1940 averaged less than 10 per cent of total production, while during the 1920's they averaged more than 25 per cent. The decline in the export trade has left a large surplus in production which, in connection with an abnormally large supply of wheat and other grains in recent years, caused congestion in a number of markets; tied up railroad cars; and caused elevators in some instances to turn away grains, and railroads to institute embargoes to prevent further congestion.

Many countries, both importing and exporting, have sought to modify the impact of the world market conditions on their own economy. Importing countries have taken measures to stimulate production and self-sufficiency. The four large exporting countries of Argen-

tina, Australia, Canada, and the United States have all undertaken various programs for the relief of growers. Such measures have been designed, in part at least, to protect the domestic price received by producers. Such plans have generally evolved towards control by the central government.[27]

In the absence of regulation, the price of wheat in the United States would be much affected by world conditions. During 1941, producers who coöperated with the Agricultural Adjustment program received an average price on the farm of about $1.16 a bushel, as compared with the world market price of 40 cents a bushel.

Differences in farming conditions, however, make these benefits mean different things to different wheat growers. There are several large areas of specialization in wheat, and the concentration on this crop reaches 27 per cent of the crop land, and the average harvest runs as high as

[27] It is interesting to note that all of these have federated systems of government, not of course without important differences. In all of them, wheat regulation is by the national government. In Argentina, wheat may be purchased only from the national Grain Board. A condition of sale to the Board, which buys at pegged prices, is the producer's agreement to become subject to restrictions on planting. See Nolan, Argentine Grain Price Guaranty, Foreign Agriculture (Office of Foreign Agricultural Relations, Department of Agriculture) May, 1942, pp. 185, 202. The Australian system of regulation includes the licensing of growers, who may not sow more than the amount licensed, and who may be compelled to cut part of their crops for hay if a heavy crop is in prospect. See Wright, Australian Wheat Stabilization, Foreign Agriculture (Office of Foreign Agricultural Relations, Department of Agriculture) September, 1942, pp. 329, 336. The Canadian Wheat Board has wide control over the marketing of wheat by the individual producer. 4 Geo. VI, c. 25, § 5. Canadian wheat has also been the subject of numerous Orders in Council. E. g., 6 Proclamations and Orders in Council (1942) 183, which gives the Wheat Board full control of sale, delivery, milling and disposition by any person or individual. See, also, Wheat Acreage Reduction Act, 1942, 6 Geo. VI, c. 10.

155 acres. Except for some use of wheat as stock feed and for seed, the practice is to sell the crop for cash. Wheat from such areas constitutes the bulk of the interstate commerce therein.

On the other hand, in some New England states less than one per cent of the crop land is devoted to wheat, and the average harvest is less than five acres per farm. In 1940 the average percentage of the total wheat production that was sold in each state, as measured by value, ranged from 29 per cent thereof in Wisconsin to 90 per cent in Washington. Except in regions of large-scale production, wheat is usually grown in rotation with other crops; for a nurse crop for grass seeding; and as a cover crop to prevent soil erosion and leaching. Some is sold, some kept for seed, and a percentage of the total production much larger than in areas of specialization is consumed on the farm and grown for such purpose. Such farmers, while growing some wheat, may even find the balance of their interest on the consumer's side.

The effect of consumption of home-grown wheat on interstate commerce is due to the fact that it constitutes the most variable factor in the disappearance of the wheat crop. Consumption on the farm where grown appears to vary in an amount greater than 20 per cent of average production. The total amount of wheat consumed as food varies but relatively little, and use as seed is relatively constant.

The maintenance by government regulation of a price for wheat undoubtedly can be accomplished as effectively by sustaining or increasing the demand as by limiting the supply. The effect of the statute before us is to restrict the amount which may be produced for market and the extent as well to which one may forestall resort to the market by producing to meet his own needs. That appellee's own contribution to the demand for wheat may be trivial by itself is not enough to remove him from the

scope of federal regulation where, as here, his contribution, taken together with that of many others similarly situated, is far from trivial. *Labor Board* v. *Fainblatt,* 306 U. S. 601, 606 *et seq.; United States* v. *Darby, supra,* at 123.

It is well established by decisions of this Court that the power to regulate commerce includes the power to regulate the prices at which commodities in that commerce are dealt in and practices affecting such prices.[28] One of the primary purposes of the Act in question was to increase the market price of wheat, and to that end to limit the volume thereof that could affect the market. It can hardly be denied that a factor of such volume and variability as home-consumed wheat would have a substantial influence on price and market conditions. This may arise because being in marketable condition such wheat overhangs the market and, if induced by rising prices, tends to flow into the market and check price increases. But if we assume that it is never marketed, it supplies a need of the man who grew it which would otherwise be reflected by purchases in the open market. Home-grown wheat in this sense competes with wheat in commerce. The stimulation of commerce is a use of the regulatory function quite as definitely as prohibitions or restrictions thereon. This record leaves us in no doubt that Congress

[28] *Swift & Co.* v. *United States,* 196 U. S. 375; *Stafford* v. *Wallace,* 258 U. S. 495; *Chicago Board of Trade* v. *Olsen,* 262 U. S. 1; *Coronado Coal Co.* v. *United Mine Workers,* 268 U. S. 295; *United States* v. *Trenton Potteries Co.,* 273 U. S. 392; *Tagg Bros. & Moorhead* v. *United States,* 280 U. S. 420; *Standard Oil Co. of Indiana* v. *United States,* 283 U. S. 163; *Currin* v. *Wallace,* 306 U. S. 1; *Mulford* v. *Smith,* 307 U. S. 38; *United States* v. *Rock Royal Co-operative, supra; United States* v. *Socony-Vacuum Oil Co.,* 310 U. S. 150; *Sunshine Anthracite Coal Co.* v. *Adkins,* 310 U. S. 381; *United States* v. *Darby, supra; United States* v. *Wrightwood Dairy Co., supra; Federal Power Commission* v. *Pipeline Co.,* 315 U. S. 575.

may properly have considered that wheat consumed on the farm where grown, if wholly outside the scheme of regulation, would have a substantial effect in defeating and obstructing its purpose to stimulate trade therein at increased prices.

It is said, however, that this Act, forcing some farmers into the market to buy what they could provide for themselves, is an unfair promotion of the markets and prices of specializing wheat growers. It is of the essence of regulation that it lays a restraining hand on the self-interest of the regulated and that advantages from the regulation commonly fall to others. The conflicts of economic interest between the regulated and those who advantage by it are wisely left under our system to resolution by the Congress under its more flexible and responsible legislative process.[29] Such conflicts rarely lend themselves to judicial determination. And with the wisdom, workability, or fairness, of the plan of regulation we have nothing to do.

III

The statute is also challenged as a deprivation of property without due process of law contrary to the Fifth Amendment, both because of its regulatory effect on the appellee and because of its alleged retroactive effect. The court below sustained the plea on the ground of forbidden retroactivity, "or in the alternative, that the equities of the case as shown by the record favor the plaintiff." 43 F. Supp. 1017, 1019. An Act of Congress is not to be refused application by the courts as arbitrary and capricious and forbidden by the Due Process Clause merely

[29] Cf. *M'Culloch* v. *Maryland*, 4 Wheat. 316, 413–415, 435–436; *Gibbons* v. *Ogden*, *supra*, at 197; *Stafford* v. *Wallace*, 258 U. S. 495, 521; *Chicago Board of Trade* v. *Olsen*, 262 U. S. 1, 37; *Helvering* v. *Gerhardt*, 304 U. S. 405, 412.

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because it is deemed in a particular case to work an inequitable result.

Appellee's claim that the Act works a deprivation of due process even apart from its allegedly retroactive effect is not persuasive. Control of total supply, upon which the whole statutory plan is based, depends upon control of individual supply. Appellee's claim is not that his quota represented less than a fair share of the national quota, but that the Fifth Amendment requires that he be free from penalty for planting wheat and disposing of his crop as he sees fit.

We do not agree. In its effort to control total supply, the Government gave the farmer a choice which was, of course, designed to encourage coöperation and discourage non-coöperation. The farmer who planted within his allotment was in effect guaranteed a minimum return much above what his wheat would have brought if sold on a world market basis. Exemption from the applicability of quotas was made in favor of small producers.[30] The farmer who produced in excess of his quota might escape penalty by delivering his wheat to the Secretary, or by storing it with the privilege of sale without penalty in a later year to fill out his quota, or irrespective of quotas if they are no longer in effect, and he could obtain a loan of 60 per cent of the rate for coöperators, or about 59 cents a bushel, on so much of his wheat as would be subject to penalty if marketed.[31] Finally, he might make other disposition of his wheat, subject to the penalty. It is agreed

[30] Section 7 of the amendment of May 26, 1941 provided that a farm marketing quota should not be applicable to any farm on which the acreage planted to wheat is not in excess of fifteen acres. When the appellee planted his wheat the quota was inapplicable to any farm on which the normal production of the acreage planted to wheat was less than 200 bushels. § 335 (d) of the Agricultural Adjustment Act of 1938, as amended by 54 Stat. 232.

[31] §§ 6, 10 (c) of the amendment of May 26, 1941.

that as the result of the wheat programs he is able to market his wheat at a price "far above any world price based on the natural reaction of supply and demand." We can hardly find a denial of due process in these circumstances, particularly since it is even doubtful that appellee's burdens under the program outweigh his benefits. It is hardly lack of due process for the Government to regulate that which it subsidizes.

The amendment of May 26, 1941 is said to be invalidly retroactive in two respects: first, in that it increased the penalty from 15 cents to 49 cents a bushel; secondly, in that, by the new definition of "farm marketing excess," it subjected to the penalty wheat which had theretofore been subject to no penalty at all, i. e., wheat not "marketed" as defined in the Act.

It is not to be denied that between seed time and harvest important changes were made in the Act which affected the desirability and advantage of planting the excess acreage. The law as it stood when the appellee planted his crop made the quota for his farm the normal or the actual production of the acreage allotment, whichever was greater, plus any carry-over wheat that he could have marketed without penalty in the preceding marketing year.[32] The Act also provided that the farmer who, while quotas were in effect, marketed wheat in excess of the quota for the farm on which it was produced should be subject to a penalty of 15 cents a bushel on the excess so marketed.[33] Marketing of wheat was defined as including disposition "by feeding (in any form) to poultry or livestock which, or the products of which, are sold, bartered, or exchanged, . . ."[34] The amendment of May 26,

[32] § 335 (c) as amended July 26, 1939, 53 Stat. 1126, 7 U. S. C. § 1335 (c).

[33] § 339, 7 U. S. C. § 1339.

[34] § 301 (b) (6) (A), (B), as amended July 2, 1940, 54 Stat. 727, 7 U. S. C. § 1301 (b) (6) (A), (B).

1941, made before the appellee had harvested the growing crop, changed the quota and penalty provisions. The quota for each farm became the actual production of acreage planted to wheat, less the normal or the actual production, whichever was smaller, of any excess acreage.[35] Wheat in excess of this quota, known as the "farm-marketing excess" and declared by the amendment to be "regarded as available for marketing," was subjected to a penalty fixed at 50 per cent of the basic loan rate for coöperators,[36] or 49 cents, instead of the penalty of 15 cents which obtained at the time of planting. At the same time, there was authorized an increase in the amount of the loan which might be made to non-coöperators such as the appellee upon wheat which "would be subject to penalty if marketed" from about 34 cents per bushel to about 59 cents.[37] The entire crop was subjected by the amendment to a lien for the payment of the penalty.

The penalty provided by the amendment can be postponed or avoided only by storing the farm marketing excess according to regulations promulgated by the Secretary or by delivering it to him without compensation;

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[35] By an amendment of December 26, 1941, 55 Stat. 872, effective as of May 26, 1941, it was provided that the farm marketing excess should not be larger than the amount by which the actual production exceeds the normal production of the farm wheat-acreage allotment, if the producer establishes such actual production to the satisfaction of the Secretary, provision being made for adjustment of the penalty in the event of a downward adjustment in the amount of the farm marketing excess.

[36] §§ 1, 2, 3 of the amendment of May 26, 1941.

[37] Section 302 (b) had provided for a loan to non-coöperators of 60% of the basic loan rate for coöperators, which in 1940 was 64¢. See United States Department of Agriculture Press Release, May 20, 1940. The same percentage was employed in § 10 (c) of the amendment of May 26, 1941, and the increase in the amount of the loan is the result of an increase in the basic loan rate effected by § 10 (a) of the amendment.

and the penalty is incurred and becomes due on threshing.[38] Thus the penalty was contingent upon an act which appellee committed not before but after the enactment of the statute, and had he chosen to cut his excess and cure it or feed it as hay, or to reap and feed it with the head and straw together, no penalty would have been demanded. Such manner of consumption is not uncommon. Only when he threshed and thereby made it a part of the bulk of wheat overhanging the market did he become subject to penalty. He has made no effort to show that the value of his excess wheat consumed without threshing was less than it would have been had it been threshed while subject to the statutory provisions in force at the time of planting. Concurrently with the increase in the amount of the penalty, Congress authorized a substantial increase in the amount of the loan which might be made to coöperators upon stored farm marketing excess wheat. That appellee is the worse off for the aggregate of this legislation does not appear; it only appears that, if he could get all that the Government gives and do nothing that the Government asks, he would be better off than this law allows. To deny him this is not to deny him due process of law. Cf. *Mulford* v. *Smith,* 307 U. S. 38.

Reversed.

[38] Wheat—507, § 728.251 (b), 6 Federal Register 2695, 2701.

Department of the Treasury
Financial Crimes Enforcement Network

Guidance

FIN-2014-G001
Issued: February 14, 2014
Subject: BSA Expectations Regarding Marijuana-Related Businesses

The Financial Crimes Enforcement Network ("FinCEN") is issuing guidance to clarify Bank Secrecy Act ("BSA") expectations for financial institutions seeking to provide services to marijuana-related businesses. FinCEN is issuing this guidance in light of recent state initiatives to legalize certain marijuana-related activity and related guidance by the U.S. Department of Justice ("DOJ") concerning marijuana-related enforcement priorities. This FinCEN guidance clarifies how financial institutions can provide services to marijuana-related businesses consistent with their BSA obligations, and aligns the information provided by financial institutions in BSA reports with federal and state law enforcement priorities. This FinCEN guidance should enhance the availability of financial services for, and the financial transparency of, marijuana-related businesses.

Marijuana Laws and Law Enforcement Priorities

The Controlled Substances Act ("CSA") makes it illegal under federal law to manufacture, distribute, or dispense marijuana.[1] Many states impose and enforce similar prohibitions. Notwithstanding the federal ban, as of the date of this guidance, 20 states and the District of Columbia have legalized certain marijuana-related activity. In light of these developments, U.S. Department of Justice Deputy Attorney General James M. Cole issued a memorandum (the "Cole Memo") to all United States Attorneys providing updated guidance to federal prosecutors concerning marijuana enforcement under the CSA.[2] The Cole Memo guidance applies to all of DOJ's federal enforcement activity, including civil enforcement and criminal investigations and prosecutions, concerning marijuana in all states.

The Cole Memo reiterates Congress's determination that marijuana is a dangerous drug and that the illegal distribution and sale of marijuana is a serious crime that provides a significant source of revenue to large-scale criminal enterprises, gangs, and cartels. The Cole Memo notes that DOJ is committed to enforcement of the CSA consistent with those determinations. It also notes that DOJ is committed to using its investigative and prosecutorial resources to address the most

[1] Controlled Substances Act, 21 U.S.C. § 801, *et seq*.
[2] James M. Cole, Deputy Attorney General, U.S. Department of Justice, *Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement* (August 29, 2013), *available at* http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.

significant threats in the most effective, consistent, and rational way. In furtherance of those objectives, the Cole Memo provides guidance to DOJ attorneys and law enforcement to focus their enforcement resources on persons or organizations whose conduct interferes with any one or more of the following important priorities (the "Cole Memo priorities"):[3]

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
- Preventing state-authorized marijuana 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 marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.

Concurrently with this FinCEN guidance, Deputy Attorney General Cole is issuing supplemental guidance directing that prosecutors also consider these enforcement priorities with respect to federal money laundering, unlicensed money transmitter, and BSA offenses predicated on marijuana-related violations of the CSA.[4]

Providing Financial Services to Marijuana-Related Businesses

This FinCEN guidance clarifies how financial institutions can provide services to marijuana-related businesses consistent with their BSA obligations. In general, the decision to open, close, or refuse any particular account or relationship should be made by each financial institution based on a number of factors specific to that institution. These factors may include its particular business objectives, an evaluation of the risks associated with offering a particular product or service, and its capacity to manage those risks effectively. Thorough customer due diligence is a critical aspect of making this assessment.

In assessing the risk of providing services to a marijuana-related business, a financial institution should conduct customer due diligence that includes: (i) verifying with the appropriate state authorities whether the business is duly licensed and registered; (ii) reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business; (iii) requesting from state licensing and enforcement authorities available information about the business and related parties; (iv) developing an understanding of the normal and expected activity for the business, including the types of

[3] The Cole Memo notes that these enforcement priorities are listed in general terms; each encompasses a variety of conduct that may merit civil or criminal enforcement of the CSA.
[4] James M. Cole, Deputy Attorney General, U.S. Department of Justice, *Memorandum for All United States Attorneys: Guidance Regarding Marijuana Related Financial Crimes* (February 14, 2014).

products to be sold and the type of customers to be served (e.g., medical versus recreational customers); (v) ongoing monitoring of publicly available sources for adverse information about the business and related parties; (vi) ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance; and (vii) refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk. With respect to information regarding state licensure obtained in connection with such customer due diligence, a financial institution may reasonably rely on the accuracy of information provided by state licensing authorities, where states make such information available.

As part of its customer due diligence, a financial institution should consider whether a marijuana-related business implicates one of the Cole Memo priorities or violates state law. This is a particularly important factor for a financial institution to consider when assessing the risk of providing financial services to a marijuana-related business. Considering this factor also enables the financial institution to provide information in BSA reports pertinent to law enforcement's priorities. A financial institution that decides to provide financial services to a marijuana-related business would be required to file suspicious activity reports ("SARs") as described below.

Filing Suspicious Activity Reports on Marijuana-Related Businesses

The obligation to file a SAR is unaffected by any state law that legalizes marijuana-related activity. A financial institution is required to file a SAR if, consistent with FinCEN regulations, the financial institution knows, suspects, or has reason to suspect that a transaction conducted or attempted by, at, or through the financial institution: (i) involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity; (ii) is designed to evade regulations promulgated under the BSA, or (iii) lacks a business or apparent lawful purpose.[5] Because federal law prohibits the distribution and sale of marijuana, financial transactions involving a marijuana-related business would generally involve funds derived from illegal activity. Therefore, a financial institution is required to file a SAR on activity involving a marijuana-related business (including those duly licensed under state law), in accordance with this guidance and FinCEN's suspicious activity reporting requirements and related thresholds.

One of the BSA's purposes is to require financial institutions to file reports that are highly useful in criminal investigations and proceedings. The guidance below furthers this objective by assisting financial institutions in determining how to file a SAR that facilitates law enforcement's access to information pertinent to a priority.

"Marijuana Limited" SAR Filings

A financial institution providing financial services to a marijuana-related business that it reasonably believes, based on its customer due diligence, does not implicate one of the Cole Memo priorities or violate state law should file a "Marijuana Limited" SAR. The content of this

[5] *See, e.g.*, 31 CFR § 1020.320. Financial institutions shall file with FinCEN, to the extent and in the manner required, a report of any suspicious transaction relevant to a possible violation of law or regulation. A financial institution may also file with FinCEN a SAR with respect to any suspicious transaction that it believes is relevant to the possible violation of any law or regulation but whose reporting is not required by FinCEN regulations.

SAR should be limited to the following information: (i) identifying information of the subject and related parties; (ii) addresses of the subject and related parties; (iii) the fact that the filing institution is filing the SAR solely because the subject is engaged in a marijuana-related business; and (iv) the fact that no additional suspicious activity has been identified. Financial institutions should use the term "MARIJUANA LIMITED" in the narrative section.

A financial institution should follow FinCEN's existing guidance on the timing of filing continuing activity reports for the same activity initially reported on a "Marijuana Limited" SAR.[6] The continuing activity report may contain the same limited content as the initial SAR, plus details about the amount of deposits, withdrawals, and transfers in the account since the last SAR. However, if, in the course of conducting customer due diligence (including ongoing monitoring for red flags), the financial institution detects changes in activity that potentially implicate one of the Cole Memo priorities or violate state law, the financial institution should file a "Marijuana Priority" SAR.

"Marijuana Priority" SAR Filings

A financial institution filing a SAR on a marijuana-related business that it reasonably believes, based on its customer due diligence, implicates one of the Cole Memo priorities or violates state law should file a "Marijuana Priority" SAR. The content of this SAR should include comprehensive detail in accordance with existing regulations and guidance. Details particularly relevant to law enforcement in this context include: (i) identifying information of the subject and related parties; (ii) addresses of the subject and related parties; (iii) details regarding the enforcement priorities the financial institution believes have been implicated; and (iv) dates, amounts, and other relevant details of financial transactions involved in the suspicious activity. Financial institutions should use the term "MARIJUANA PRIORITY" in the narrative section to help law enforcement distinguish these SARs.[7]

"Marijuana Termination" SAR Filings

If a financial institution deems it necessary to terminate a relationship with a marijuana-related business in order to maintain an effective anti-money laundering compliance program, it should

[6] Frequently Asked Questions Regarding the FinCEN Suspicious Activity Report (Question #16), *available at:* http://fincen.gov/whatsnew/html/sar_faqs.html (providing guidance on the filing timeframe for submitting a continuing activity report).

[7] FinCEN recognizes that a financial institution filing a SAR on a marijuana-related business may not always be well-positioned to determine whether the business implicates one of the Cole Memo priorities or violates state law, and thus which terms would be most appropriate to include (i.e., "Marijuana Limited" or "Marijuana Priority"). For example, a financial institution could be providing services to another domestic financial institution that, in turn, provides financial services to a marijuana-related business. Similarly, a financial institution could be providing services to a non-financial customer that provides goods or services to a marijuana-related business (e.g., a commercial landlord that leases property to a marijuana-related business). In such circumstances where services are being provided indirectly, the financial institution may file SARs based on existing regulations and guidance without distinguishing between "Marijuana Limited" and "Marijuana Priority." Whether the financial institution decides to provide indirect services to a marijuana-related business is a risk-based decision that depends on a number of factors specific to that institution and the relevant circumstances. In making this decision, the institution should consider the Cole Memo priorities, to the extent applicable.

file a SAR and note in the narrative the basis for the termination. Financial institutions should use the term "MARIJUANA TERMINATION" in the narrative section. To the extent the financial institution becomes aware that the marijuana-related business seeks to move to a second financial institution, FinCEN urges the first institution to use Section 314(b) voluntary information sharing (if it qualifies) to alert the second financial institution of potential illegal activity. See *Section 314(b) Fact Sheet* for more information.[8]

Red Flags to Distinguish Priority SARs

The following red flags indicate that a marijuana-related business may be engaged in activity that implicates one of the Cole Memo priorities or violates state law. These red flags indicate only possible signs of such activity, and also do not constitute an exhaustive list. It is thus important to view any red flag(s) in the context of other indicators and facts, such as the financial institution's knowledge about the underlying parties obtained through its customer due diligence. Further, the presence of any of these red flags in a given transaction or business arrangement may indicate a need for additional due diligence, which could include seeking information from other involved financial institutions under Section 314(b). These red flags are based primarily upon schemes and typologies described in SARs or identified by our law enforcement and regulatory partners, and may be updated in future guidance.

- A customer appears to be using a state-licensed marijuana-related business as a front or pretext to launder money derived from other criminal activity (i.e., not related to marijuana) or derived from marijuana-related activity not permitted under state law. Relevant indicia could include:
    - The business receives substantially more revenue than may reasonably be expected given the relevant limitations imposed by the state in which it operates.
    - The business receives substantially more revenue than its local competitors or than might be expected given the population demographics.
    - The business is depositing more cash than is commensurate with the amount of marijuana-related revenue it is reporting for federal and state tax purposes.
    - The business is unable to demonstrate that its revenue is derived exclusively from the sale of marijuana in compliance with state law, as opposed to revenue derived from (i) the sale of other illicit drugs, (ii) the sale of marijuana not in compliance with state law, or (iii) other illegal activity.
    - The business makes cash deposits or withdrawals over a short period of time that are excessive relative to local competitors or the expected activity of the business.

[8] Information Sharing Between Financial Institutions: Section 314(b) Fact Sheet, *available at: http://fincen.gov/statutes_regs/patriot/pdf/314bfactsheet.pdf.*

- Deposits apparently structured to avoid Currency Transaction Report ("CTR") requirements.

- Rapid movement of funds, such as cash deposits followed by immediate cash withdrawals.

- Deposits by third parties with no apparent connection to the accountholder.

- Excessive commingling of funds with the personal account of the business's owner(s) or manager(s), or with accounts of seemingly unrelated businesses.

- Individuals conducting transactions for the business appear to be acting on behalf of other, undisclosed parties of interest.

- Financial statements provided by the business to the financial institution are inconsistent with actual account activity.

- A surge in activity by third parties offering goods or services to marijuana-related businesses, such as equipment suppliers or shipping servicers.

- The business is unable to produce satisfactory documentation or evidence to demonstrate that it is duly licensed and operating consistently with state law.

- The business is unable to demonstrate the legitimate source of significant outside investments.

- A customer seeks to conceal or disguise involvement in marijuana-related business activity. For example, the customer may be using a business with a non-descript name (e.g., a "consulting," "holding," or "management" company) that purports to engage in commercial activity unrelated to marijuana, but is depositing cash that smells like marijuana.

- Review of publicly available sources and databases about the business, its owner(s), manager(s), or other related parties, reveal negative information, such as a criminal record, involvement in the illegal purchase or sale of drugs, violence, or other potential connections to illicit activity.

- The business, its owner(s), manager(s), or other related parties are, or have been, subject to an enforcement action by the state or local authorities responsible for administering or enforcing marijuana-related laws or regulations.

- A marijuana-related business engages in international or interstate activity, including by receiving cash deposits from locations outside the state in which the business operates, making or receiving frequent or large interstate transfers, or otherwise transacting with persons or entities located in different states or countries.

- The owner(s) or manager(s) of a marijuana-related business reside outside the state in which the business is located.

- A marijuana-related business is located on federal property or the marijuana sold by the business was grown on federal property.

- A marijuana-related business's proximity to a school is not compliant with state law.

- A marijuana-related business purporting to be a "non-profit" is engaged in commercial activity inconsistent with that classification, or is making excessive payments to its manager(s) or employee(s).

Currency Transaction Reports and Form 8300's

Financial institutions and other persons subject to FinCEN's regulations must report currency transactions in connection with marijuana-related businesses the same as they would in any other context, consistent with existing regulations and with the same thresholds that apply. For example, banks and money services businesses would need to file CTRs on the receipt or withdrawal by any person of more than $10,000 in cash per day. Similarly, any person or entity engaged in a non-financial trade or business would need to report transactions in which they receive more than $10,000 in cash and other monetary instruments for the purchase of goods or services on FinCEN Form 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business). A business engaged in marijuana-related activity may not be treated as a non-listed business under 31 C.F.R. § 1020.315(e)(8), and therefore, is not eligible for consideration for an exemption with respect to a bank's CTR obligations under 31 C.F.R. § 1020.315(b)(6).

* * * * *

FinCEN's enforcement priorities in connection with this guidance will focus on matters of systemic or significant failures, and not isolated lapses in technical compliance. Financial institutions with questions about this guidance are encouraged to contact FinCEN's Resource Center at (800) 767-2825, where industry questions can be addressed and monitored for the purpose of providing any necessary additional guidance.

Gun Law

Submitted by Benjamin L. Bunker

GUN LAW

A. Constitutional Components of Firearms Law

- **U.S. Constitution, Bill of Rights, Second Amendment**
- *"A well regulated Militia, being necessary to the security of a free State, the right of the people to keep and bear Arms, shall not be infringed."*
- *Heller v. District of Columbia,* 554 U.S. 570 (2008)
  - Affirmed the right to reasonable self-defense with a firearm
  - Individual right to a firearm
- *McDonald v. Chicago,* 561 U.S. 742 (2010)
  - Second Amendment applies to the states as well (via 14th amendment)

B. Firearms Laws: What Attorneys Need to Know

C. Concealed and Open Carry Law

D. Title I Firearms and Their Regulation

The Gun Control Act of 1968 ("Title I")

E. Title 2 Firearms: Unique and Misunderstood

The National Firearms Act of 1934 ("Title II")

F. Firearms Dealers and Licensing Requirements

G. Gun Dealer and Ownership Legal and Liability Concerns

H. What Guns are Legal and Who can Buy Them

I. Sales and Transfers, Including Gun Shows

A. Constitutional Components of Firearms Law

U.S. Constitution, Bill of Rights, Second Amendment

> *"A well regulated Militia, being necessary to the security of a free State, the right of the people to keep and bear Arms, shall not be infringed."*

Heller v. District of Columbia, 554 U.S. 570 (2008)

- Affirmed the right to reasonable self-defense with a firearm
- Individual right to a firearm

McDonald v. Chicago, 561 U.S. 742 (2010)

- Second Amendment applies to the states as well (via 14th amendment)

B. Firearms Laws: What Attorneys Need to Know

Firearms law encompasses a multitude of practice areas, such as constitutional law, contracts law, criminal law, products liability, intellectual property, estate planning, business law, etc. Firearms issues can overlap many of these areas at the same time.

Additional considerations are local, county, and state laws in addition to federal requirements. Firearms are a hot-button issue and popular opinion and politics are playing a role in how laws are created and enforced. Changes can be fast and significant and counsel needs to keep current.

C. Concealed and Open Carry Law

There are at least three major types of concealed carry authorized in various states as follows: (1) *shall* issue; (2) *may* issue: and (3) unrestricted (or "constitutional carry").

Shall Issue

Shall issue states require a license to carry concealed firearms, but the granting of the license is subject to criteria, typically set forth at the state level in its statutory code. Provided that a Carry

Concealed Weapon ("CCW") applicant complies with the requirements, the issuing agency (usually a sheriff for the county the applicant resides) MUST issue the permit. No discretion or demonstration of "good cause" is necessary in a "shall issue" jurisdiction.

Typically, the licensing requirements include residency, minimum age, submitting fingerprints, passing a background check, attending a certified training class, passing a practical qualification (target shooting), and paying a fee. Requirements vary by jurisdiction and can include some or all of the above.

May Issue

A "may issue" jurisdiction not only requires a permit/license to carry a concealed firearm, but the issuance is based on the discretion of the local issuing authorities, usually a sheriff's or police department. In addition to the commonly found requirements of a "shall issue" jurisdiction, the local authority has open discretion on whether to issue the permit and often does not have to provide a reason for denial.

In many "may issue" locations there is an additional "good cause" requirement. Any applicant must provide evidence of "good cause" as to why the issuing authority should issue the CCW permit. Self-defense alone is not, *per se*, enough to satisfy the "good cause" requirement. Some issuing authorities arbitrarily deny CCW applications without providing a reason for the denial. Moreover, issuing authorities may later revoke issued CCW permits or deny renewal based on the determination that the "good cause" used prior no longer exists.

Unrestricted or "Constitutional Carry"

Unrestricted or "constitutional carry" jurisdictions do not require a permit to CCW. *Fully* unrestricted states do not require a permit for lawful open or concealed carry, while *partially* unrestricted states require a permit for some forms of carry but not for others.

Open Carry

Open Carry is exactly what the name states, carrying a firearm in a "open" or "unconcealed" fashion. Open Carry can be explicitly established via state statute or in the case of Nevada, a lack of any statute prohibiting open carry. Additionally, in some jurisdictions (e.g., Nevada) a permit to "open carry" may not be required.

D. Title I Firearms and Their Regulation

The Gun Control Act of 1968 ("Title I")

The GCA was passed in 1968 and primarily focused on the regulation of interstate commerce in firearms. *18 U.S.C.* It instituted the requirement for interstate transfer of firearms through licensed dealers only, thus creating the FFL ("Federal Firearms License") network that we have today. Additional regulations were codified, including marking requirements, importation restrictions, and "prohibited persons" (later augmented by the Brady Handgun Violence Prevention Act of 1993).

The GCA is commonly referred to as "Title I" of the U.S. Firearms laws and governs many of the more common types of firearms. Most common firearms are designated "Title I" firearms in the industry and by ATF: pistols/revolvers, shotguns, rifles, and semi-automatic rifles. There is no additional regulation for Title I firearms, unlike the items found under "Title II."

E. Title 2 Firearms: Unique and Misunderstood

The National Firearms Act of 1934 ("Title II")

The NFA is the progenitor of the GCA and all other Federal firearms regulations. *26 U.S.C.* This law originated in 1934 as an attempt to curb the rampant crime by taxing and registering certain firearms. Any firearm or other item that fell under the NFA required the payment of a $200 tax stamp and registration through the National Firearms Registration and Transfer Record ("NFA Registry").

The NFA established certain categories for regulation, namely: (1) short-barreled rifles; (2) short-barreled shotguns; (3) suppressors/silencers; (4) machine-guns; (5) destructive devices; and

(6) any other weapons ("AOW"). The ATF has created very specific definitions for each category, including barrel and overall length dimensions for short-barreled rifles and shotguns. Interstate transportation of Title II items is also regulated, requiring *prior* notice to ATF of what item(s) will be transported, where, and when.

F. Firearms Dealers and Licensing Requirements

Firearms dealers must receive federal licensing issued by the Bureau of Alcohol, Tobacco, Firearms and Explosives ("ATF"). A Federal Firearms License ("FFL") is required under the Gun Control Act of 1968. Dealers must first ensure that local, county, and state licensing for the business will be compliant. Location (landlord) and zoning are additional considerations that must be reviewed prior to submitting an application for an FFL. Failure to ensure compliance with these issues will likely result in the ATF rejecting the FFL application.

The FFL application is ATF's Form 7 and requires specific background information for all of the "Responsible Persons" including fingerprints for background checks. The ATF will contact business licensing, zoning, the landlord, and any other entity necessary to make a determination that the FFL can legally operate in its location.

G. Gun Dealer and Ownership Legal and Liability Concerns

The Protection of Lawful Commerce in Arms Act (15 U.S.C. §§ 7901-7903), protects firearms manufacturers and dealers from being held liable when crimes have been committed with their products. This does not protect against strict product liability, breach of contract, criminal misconduct or other similar actions.

Both civil and criminal liability are relevant concerns for gun owners. Although self-defense is justified, civil and criminal liability are both concerns. The killing or wounding of innocent bystanders can result in criminal and civil penalties. Carrying while intoxicated, brandishing, or threatening with a firearm can also result in penalties.

Recently, statutes like "Stand Your Ground" and "Castle Doctrine" provide protection to those using a firearm in self-defense. "Stand Your Ground" laws do not require the non-aggressor

to retreat and also permit the use of lethal force if justified. The "Castle Doctrine" applies to homes and also eliminates a duty to retreat.

Even in light of the trend to added protections for use of force by CCW holders, lethal force must be used only as a last resort. Errors that can cause harm may result in civil liability and be outside the scope of protective statutes. New services have arisen to protect CCW holders in the form of "insurance" offerings that provide legal representation for CCW holders charged with criminal (and even civil) penalties. Some of these include: USCCA, CCW Safe, and NFA Carryguard, to name a few.

H. What Guns are Legal and Who can Buy Them

Legality of firearms will vary based on local, county, and state laws in addition to the already existing requirements of federal law. Many jurisdictions will limit availability to certain models (e.g., California), certain build dates, or other features.

Purchasers must be either 18 years of age (rifles and shotguns) or 21 years of age (handguns) unless otherwise modified by local, county, or state laws. ATF's Form 4473 is the required form that a purchaser must complete when acquiring a firearm through an FFL (or otherwise required by state law, such as universal background checks). Section 11 of the 4473 (11-12) is a checklist of prohibitive issues that can affect a potential purchaser.

I. Sales and Transfers, Including Gun Shows

Sales/transfers from an FFL requires that the potential purchaser complete the ATF Form 4473 and undergo a background check (in most instances). In some states, a valid CCW permit may exempt a purchaser from the background check but the 4473 must still be completed.

Private party transfers or face-to-face sales, if from a private individual and NOT an FFL, do not necessarily require a background check. In some states that require "universal background checks," the parties will usually have to go to an FFL for the transaction in order that the FFL may facilitate the background check process. Gun shows fall under these requirements as well and often an FFL is selected to operate the background check process for the gun show for all purchasers.

The so-called “gun show loophole” is a myth and does not actually exist as a gun show is governed by the same laws as FFLs and private parties.

Craft Beer, Distillery and Wine Law

Submitted by Jeffrey C. O'Brien

Craft Beer, Distillery and Wine Law

Marijuana, Guns, Craft Beer, Wine and Gambling Law

Jeff O' Brien

chestnut cambronne
ATTORNEYS AT LAW

Brewery and Distillery Business Entity Selection, Formation, Finance, and Insurance

Craft Beer, Distillery and Wine Law

Jeff O' Brien

Entity Formation

- Partnership
  - occurs when two or more people agree to conduct business together.
  - no specific documentation is required before a partnership is formed

Entity Formation

- Limited Liability Partnership
  - Partners in an LLP have limited personal liability
  - governed by its own state law separate and distinct from the law of a general partnership
  - General partners vs. limited partners

Entity Formation

- Subchapter S Corporation ("S Corp")
  - Must make an election with the IRS
  - Restrictions on who can own shares of an S Corp
  - All shareholders have the same rights
  - Possible SE Tax Minimization
  - Preferable to C Corporation for small, closely held businesses (no double tax)

Entity Formation

- Limited Liability Company (LLC)
  - Flexible structure
  - Ability to vary allocation of governance rights and financial rights
  - Single member LLC "disregarded" for federal income tax purposes; sole proprietorship income
  - Drawback: full SE tax (FICA applies to all income whether salary or profits)

S Corp vs. LLC

- FICA Tax Minimization – S Corp
- Flexibility – LLC
- BUT: DON'T WORRY: Most state corporation and LLC statutes provide for a mechanism to convert an LLC to a corporation and a corporation to an LLC

Documentation and State Filing Requirements

- Standard Documents

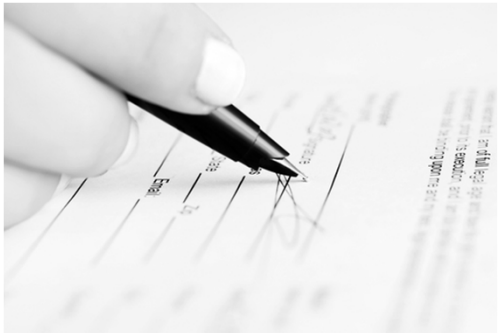
S Corporation

- Articles of Incorporation
- Bylaws
- Initial Written Actions of Shareholders/Directors
- Shareholder Control Agreement (w/ Buy-Sell Provisions)
- Form SS-4
- Form 2553 (S Election)

LLC

- Articles of Organization
- Operating Agreement
- Initial Written Actions
- Form SS-4

Drafting and Negotiating Formation Agreements



Brewery Financing Challenges – Crowdfunding and More

- What is a security?
  - 1933 Act default requires registration of any securities offering
  - Alternative: find an applicable exemption from registration
  - Also need to find an exemption from registration under state Blue Sky laws (each state where an investor resides)
- Accredited Investors
- Investment Capital
  - Section 4(2)
  - Regulation D
  - Rule 504
  - Rule 505
  - Rule 506 (now 506(b))

Brewery Financing Challenges – Crowdfunding and More

- Structuring a Private Offering
  - What percentage of ownership to sell?
  - Difference between voting and financial rights
  - Preferred distributions
  - “Sunset” provisions – call rights, put rights, etc.

Local, State, and Federal Registration, Licensing, Labeling and Regulatory Compliance

Craft Beer, Distillery and Wine Law

Jeff O’Brien

Federal Regulatory Framework

- **Alcohol and Tobacco Tax and Trade Bureau (TBB)**
  - The Alcohol and Tobacco Tax and Trade Bureau (TTB) regulates craft beer at the federal level.
  - Anyone brewing beer for sale must obtain a Brewer's Notice from the TTB. You can find the form online at their website but be aware the process can take on
  - average 129 days.
  - The application requires a heavy amount of paperwork, including personal information for every officer, director, and shareholder who holds at least 10% interest in the company.

Federal Regulatory Framework

- **Food and Drug Administration (FDA)**
  - Federally regulates any "facility that manufactures, processes, packs, or holds food or beverages – including alcoholic beverages – for consumption in the United States."
  - You must register with the FDA biannually, but there is no fee involved.

State Regulatory Framework

Wholesaler/Manufacturer's Intoxicating Liquor License

- In Minnesota, a brewery must obtain this license. This license must be renewed annually. Takes 30 days to process and can cost anywhere from $20 - $15,000 depending on the type of facility or license.
- **Requirements:**
  - $10,000 Surety Bond;
  - Be at least 21 years old;
  - Has not had a licensed issued under Minn. Stat. § 340A revoked within the past years; and
  - Not been convicted of a felony within the past 5 years or any willful violation of federal, state, or local ordinances governing the manufacture, sale, distribution, or possession for sale of distribution of alcoholic beverages

State - Level Registration

- While the TTB's licensing requirements and regulations apply for breweries and distilleries in any state within the U.S., state and local laws vary by jurisdiction.

- Be aware of which agency or agencies are responsible for reviewing your application and provide such agency/agencies with all required and requested documentation in order to ensure expeditious review and approval.

Local Regulatory Framework

- State specific

  Example) Minnesota licensing for growlers and tap/cocktail rooms

- Must obtain license from Municipality even though it is state regulated

Top Permitting and Licensing Issues

- First and foremost, it is imperative to understand what permits and licenses must be obtained at each level of government before operations can legally begin.
- At the **Federal level,** when you are seeking a brewer's notice or distilled spirits plant license, be sure that your application is complete and accurate, as incomplete applications will not be reviewed and will ultimately be dismissed.
- At the **State level**, be aware of which agency or agencies are responsible for reviewing your application and provide such agency/agencies with all required and requested documentation in order to ensure expeditious review and approval.
- It is also imperative to understand what **local requirements** exist as to the brewery or distillery, be they taproom/cocktail room licenses or other issues (such as growler sales restrictions and/or garden variety land use/zoning requirements).

Navigating TBB Labeling Regulations: Federal Level

- At the federal level, breweries and distilleries are regulated via the Alcohol and Tobacco Tax and Trade Bureau, an agency falling under the U.S. Department of Treasury.
  - The TTB handles all federal liquor law issues including tax revenues, permits, licenses, tax audits, trade investigation and labels.

- The TTB requires anyone brewing beer for sale to acquire a Brewer's Notice. Historically, the process for obtaining a Brewer's Notice through the TTB was time consuming, but with the recent craft brewing and distilling boom, the TTB has streamlined the process through its Permits Online site, https://www.ttbonline.gov/permitsonline.

Navigating TBB Labeling Regulations: Federal Level

- Information and documents to be submitted to the TTB in connection with the Brewer's Notice application include the following:
  - Articles of Organization (LLC) / Articles of Incorporation Corp.)
  - Operating Agreement (LLC) / By Laws (Corp.)
  - Federal EIN (from IRS)
  - Owner Officer Questionnaires (for each owner of 10%+ and each officer)
  - List of all owners and officers identifying percentage of voting ownership, amount of funds invested, etc. (if owner is an entity, EIN)
  - Source of Funds Documents (bank statements, loan documents, etc.)
  - Diagram of Premises
  - Description of Property (usually metes & bounds is best)
  - Power of attorney (if being filed by an attorney)
  - Other (historic buildings, variance request, etc.

Navigating TBB Labeling Regulations: Federal Level

CONTINUED

- Description of Equipment (more reviewers are requiring this, at least provide size of tanks)
- Description of the Building (walkthrough of the brewery premises)
- Environmental Questionnaire (number of employees, amount of waste, disposal of liquid and solid waste, electric/gas provider name, etc.)
- Supplemental (disposal of waste into navigable waterways, etc.)
- Brewer's Bond
- Consent of Surety (if using a non-contiguous warehouse, alternating premises between a brewery and a distillery, running an alternating proprietorship, etc.)
- Lease agreement or mortgage (with permission to use premises as a brewery/distillery)
- an attorney

Navigating TBB Labeling Regulations: Federal Level

CONTINUED

- Assumed name registration (if applicable)
- Security statement
- Designation of a main contact person
- Copy of ID for main contact person
- Signing authority resolution for application contact
- TTB's Signing Authority Form

Navigating TBB Labeling Regulations: State Licensing Issues

- While the TTB's licensing requirements and regulations apply for breweries and distilleries in any state within the U.S., state and local laws vary by jurisdiction.

Navigating TBB Labeling Regulations: Formula Approvals

- **Beer Formulas:**
  - Beers do not typically require a formula approval, unless they contain a non-traditional beer ingredient or are made using a non-traditional brewing method.
  - In 2015, TTB issued a ruling broadly expanding the definition of "traditional." Under the new rule, traditional ingredients and processes have been expanded, and are listed in the attachment on the next page.
  - If the beer includes a "non-traditional" fruit, spice (e.g., elderberry), or "sweetener" (e.g., aspartame), or contains a coloring (e.g., Blue No. 1), flavoring (e.g., an extract), or TTB limited ingredient (e.g., calcium chloride), or is made by a "non-traditional" process (e.g., "ice distilling"), the beer requires a TTB formula approval before TTB will issue a COLA approval. For more information on ingredient issues, see Appendix 1.

Navigating TBB Labeling Regulations: Formula Approvals

- **Spirit Formulas:**
  - Most traditional spirits do not require a formula approval, unless they contain a restricted product (e.g., thujone), or are infused with flavors or colored.
  - Occasionally, a product must also be sent in to TTB's lab for analysis. Lab analysis is more typically required for imported products to make sure certain requirements are met. TTB's chart is attached hereto as Appendix 2, which shows if/when formula and/or laboratory approval is required for a distilled spirits product prior to label submission.
  - Similarly, anyone seeking to produce distilled spirits must obtain a distilled spirits plant license through the TTB with similar requirements as for the Brewer's Notice.

Navigating TBB Labeling Regulations: Labeling

- The Secretary has delegated to the Alcohol and Tobacco Tax and Trade Bureau (TTB) authority to administer the regulations promulgated under section 105(e). Section 105(e) and the TTB regulations require a Certificate of Label Approval ("COLA") for each alcohol beverage product regulated by the agency. TTB issues COLAs on TTB Form 5100.31.
- First, you must register for the COLA's. Appendix 3 contains instructions on how to successfully register using the online system. If you choose not to file electronically, you must TTB Form 5100.3, in duplicate form, to the following address:
  - **Advertising, Labeling and Formulation Division**
    Alcohol and Tobacco Tax and Trade Bureau
    1310 G Street, NW, Box 12
    Washington, DC 20005

Navigating TBB Labeling Regulations: Labeling

- For many alcohol beverage products, TTB requires a product evaluation to determine whether a proposed label identifies the product in an adequate and non-misleading way. Pre-COLA product evaluation entails a review of a product's ingredients and formulation and also may include a laboratory analysis of the product. Laboratory analysis involves a chemical analysis of a product.

- The relevant Federal regulations for labeling and advertising of malt beverages can be found Part 7 of Title 27 of the Code of Federal Regulations. Processing times for COLA's can be found : https://www.ttb.gov/labeling/processing-times.shtml.

Navigating TBB Labeling Regulations: Permission to Re-label:

- Application for permission to re-label shall be accompanied by:
  - two complete sets of the old labels and
  - two complete sets of any proposed labels
  - a statement of the reasons for relabeling,
  - the quantity and the location of the malt beverages, and
  - the name and address of the person by whom they will be relabeled.

Land Use, Zoning, and Environmental Issues

- **Industrial Waste & Water**
  - Breweries use a substantial amount of water and create a large amount of byproduct waste through their operations. The spent grain is considered “industrial waste and must be handled accordingly”.
  - Be aware that some cities and locations are not friendly to breweries because they use a substantial amount of water. Additionally, at drought-stricken areas, your brewery will need to expend more on water as it may be more expensive.

Land Use, Zoning, and Environmental Issues

- **Pollutants**
  - Brewing creates pollutants that must be handled appropriately. These pollutants are governed by different agencies.
  - “The wastewater created by boilers, referred to as effluent, is regulated by the Environmental Protection Agency (EPA) for nitrogen oxide level.”
  - Plan to have a silo? You need to obtain a permit from the Air Pollution Control District (APCD).

Land Use, Zoning, and Environmental Issues

- **Zoning & Licenses**
  - In Minnesota no license to sell intoxicating liquor will be issues within the following areas:
    - Within the Capitol or on the Capitol grounds;
    - On the State Fairgrounds;
    - On the campus of the College of Agriculture of the University of Minnesota;
    - Within 1,000 ft of a state hospital, training school, reformatory, prison, or other institution under the supervision or control of the commissioner of human services or corrections;
    - Within any town or municipality that votes no in favor of liquor licensing
    - Within 1,500 ft of any public school not within a city; AND
    - Where restricted against commercial use through zoning. Minn. Stat. 340.412

Considerations for Clients Doing Business in Multiple States

- Onus is on the brewery to ensure they are compliant with each state and federal law.

- Non-extensive checklist for laws:
  - Environmental laws in different states;
  - Zoning;
  - Licensing;
  - Labeling;

Federal and State Tax Reporting Requirements

Craft Beer, Distillery and Wine Law

Jeff O’Brien

Small BREW

- Recalibrated the federal beer excise tax small brewers pay on each barrel of beer produced
- $16 per barrel on first 6 million barrels
- $18 per barrel for remaining barrels
- $3.50 per barrel for first 60,000 barrels for production under 2 million barrels
- Reduced tax rates on distilled spirits

Small BREW

- Take full advantage of the existing exemptions.
- This means:
  - sales of growlers (or their can equivalents, called "crowlers") out of the brewery and
  - operation of a taproom for on-premises sales of beer, as well as exercising self-distribution rights in the early life of the brewery to build the brand(s).

TBB Audits: Common Errors and Penalties

- **Critical Recordkeeping, Production and Inventory Mistakes**
  - Software options available to assist with record keeping - Only as accurate as the data entered
    - Maintain daily records of activity
    - Keep track of inventory adjustments
    - Account for waste and disposal of product
    - Have controls in place to ensure information entered and pulled for reporting is timely — i.e., daily rather than weekly
    - Records should be retained for a minimum of 3 years

TBB Audits: Common Errors and Penalties

- Most common daily recordkeeping mistakes
  - Accurately report the amount of beer returned to the brewery
  - Properly maintain records regarding destruction of beer
  - Appropriately record lab sample removals
  - Appropriately report, record, or maintain supporting documents regarding losses or shortages

TBB Audits: Common Errors and Penalties

- Take inventory of product on the first of each month
- Document the inventory count(s)
- Required information:
  - Date taken
  - Quantity of beer and cereal beverage on hand;
  - Losses, gains, and shortages; and
  - Signature — under penalties of perjury — of the brewer or person taking inventory

Frequent Mishaps: Tanks and Measuring Devices

Recording beer that is removed for lab samples

- Every tank, vat, cask, or other container that a brewer uses or intends to use as a receptacle for wort, beer, or concentrate must be "durably marked with a serial number and capacity.“
- All measuring devices must be tested periodically
- Records of these tests must be made available to TTB officers upon inspections
- Records required:
  - Date of test
  - Identification of device(s) tested
  - Test results
  - Any corrective actions (adjustment/repair) taken

Conversion Factors in Calculating Barrel Equivalent Amounts

- 1 Barrel (bbl) = 31 gallons
- 1 US Keg = 15 gallons
- 1 US sixtel (pony keg) = 5.166667 gallons
- 1 US case of beer = 2.25 gallons

Excise Tax Returns, Computation of Tax and Determination Mistakes

- Tax is calculated on the beer which is reported to be removed for consumption or sale in the United States
- Reported tax amounts should match Brewer's Report of Operations
- Any adjustments should be documented/explained in the appropriate section on form

Brewer’s Report of Operations (BROP)

- Required form to report operations such as:
  - Inventory levels
  - Production and waste amounts
  - Packaging amounts
  - Removals of product
- Timely records are required to ensure reported data is accurate

Negotiating/ Drafting Brewery and Distillery Contracts

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Distribution Agreements

- Laws vary from state to state
- Creation
- Termination
- Scope of agreement
- Small brewer exemptions

Contract Production Agreements

- Definition: a brewery that hires another brewery to produce its beer. The licensor generally handles marketing and brand development of the beer, while leaving the brewing and packaging to the licensee brewery.

- Pros of Contract Brewing:
  - Can help alleviate producer brewery supply issues to meet demands.
  - Producer breweries avoid costs since they do not need to own a brewing facility

Agreements with Suppliers and Licensing Agreements

Alternating Proprietorships

- Definition: An arrangement in which two or more people take turns using the physical premises of a brewery. Generally, the proprietor of an existing brewery, the "host brewery", agrees to rent space and equipment to a new "tenant brewer."
- Pros of an Alternating Proprietorship:
  - Tenant brewers can develop a brand before they are ready to invest in their own premises and equipment.
  - Tenant brewer may be eligible for a lower tax rate on beer.
  - Host breweries can offset their investment by renting out their excess capacity.

Alternating Proprietorship vs. Contract Brewing

	Alt Prop	Contract Brewing
Title Ownership	Tenant brewer holds title to its beer, including the ingredients and raw materials it uses to produce its beer, during all stages of production.	Contract brewer holds title to the beer, including the ingredients and raw materials used to brew the beer, during all stages of production.
Record Keeping	Tenant brewer and host brewer each retain their own records for production and removal of beer and each provides reports to the TTB.	Contract brewer retains all records of production and removal of beer and provides reports to the TTB.
Taxes	Tenant brewer and host brewer are individually responsible for paying their own taxes on their own beer removed from the brewery.	Contract brewer is solely responsible for paying taxes on beer removed from the brewery.
Brewer Licensure	Tenant brewer and host brewer must each qualify as a brewer and have separate licenses.	Only the contract brewer must qualify as a brewer, so the producer brewer does not need a license.
Ease of Paperwork	Requires significant paperwork for both parties.	Simple agreement; Brand is added to the contract brewer's Notice.

Equipment, Retail, Production



Distribution Space Leases

- A new brewery or distillery owner will most likely lease a building at the start, and negotiating a suitable lease is a crucial step in the process.
- Commercial lease agreements typically come in one of two varieties: "triple net" and "gross."
  - Triple Net
  - Gross

Additional Contracts and Agreements

- Breweries and distilleries, like most businesses, face a myriad of insurance requirements. In addition to the surety bond required to obtain their license, breweries and distillers will need several types of coverages including:
  - General liability insurance;
  - Workers compensation; and
  - Dram shop (if the business is serving alcohol for on-premise consumption).

Intellectual Property, Marketing and Advertising

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Jeff O'Brien

Purpose of Trademarks

- Indicate the source of a product
- Distinguish products from each other and from other competitors
- Protect a company's investment in its business and brand
- Protect consumer expectations of quality and consistency

Breweries in the US

	2012	2013	2014	2015	2016	2017
Regional Craft Breweries	97	119	135	178	186	202
Microbreweries	1,143	1,471	2,076	2,626	3,196	3,812
Brewpubs	1,180	1,308	1,528	1,740	2,042	2,252
Large non-craft	23	23	26	30	51	71
Other non-craft	32	31	20	14	16	35
Total	2,475	2,952	3,785	4,588	5,491	6,372

Definitions:

- Regional craft brewery: annual product of between 15,000 and 6,000,000 barrels
- Microbrewery: less than 15,000 barrels per year, with 75% or more of its beer sold offsite
- Brewpub: restaurant-brewery that sells 25 percent or more of its beer on site
- "Craft" is a reference to the majority of the beer being marked by innovative beers

Beer without Trademarks

What Can Qualify as a Trademark?

- Nearly any matter that distinguishes the source of one product from another, including:
  - Words
  - Designs
  - Color(s)
  - Product Configurations, Packaging, Containers
  - Sales Environment
  - Scents
  - Sounds
  - Touch

Non-Traditional Trademarks: Trade Dress

- To be protectable, trade dress must be both non-functional and distinctive
  - Functionality: any attribute that makes the product more useful, or more easily used, or that contributes to the ease or economy of manufacture or distribution
    - Utilitarian Functionality: the product feature is either essential to the use or purpose of the article or affects the cost or quality of the article
    - Aesthetic Functionality: the product feature is one, the exclusive use of which, would put competitors at a non-reputation related disadvantage

Non-Traditional Trademarks: Trade Dress

- To be protectable, trade dress must be both non-functional and distinctive
  - Distinctiveness: a product or its attribute's ability to identify a single source of goods or services, even if the source is unknown
    - Inherent: immediately capable of identifying a source of origin for a good or service
    - Acquired: trade dress that has obtained distinctiveness through use or promotion over time

Beer and Wine

- Likelihood of confusion established by showing that the goods are related in some manner and/or that the circumstances surrounding their marketing give rise to the mistaken belief that a the goods emanate from the same source

Clearance: Can I Use the Mark?

- Why conduct clearance searches?
  - Avoid disputes with third-parties
    - And potential litigation costs
  - Avoid lost investment of time and money due to rebranding
- Two main types: preliminary and comprehensive
  - Preliminary searches are quick “knock out” searches of the USPTO to identify clear problems
  - Comprehensive searches look at the USPTO and common law uses (websites, state databases, etc.)

Databases to Search

- Federal
  - U.S. Patent and Trademark Office
  - Alcohol and Tobacco Tax and Trade Bureau (TTB)
- State Licensing Agencies
  - State Liquor Licensing
  - Secretary of State (business entities and trademarks)
- Internet and Common Law
  - Google and Untappd

How Much Clearance?

- Best practice: always conduct preliminary search
  - Identify marks with nationwide rights that would be difficult to defend against
- Comprehensive search for brewery name
  - Likely cost prohibitive for individual beer names
  - Consider trademark search engine
- Considerations
  - Will sales be regular, frequent, or significant?
  - How expensive to rebrand if a third-party objects?
  - What extent of distribution, if any?

Adopt Strong Marks at the Outset

- Strong marks provide wider range of exclusivity
  - Competitors can get closer to weak marks with own brands
- Strong marks are immediately protectable
  - Weak marks may require acquired distinctiveness
- Acquired distinctiveness through extensive use
  - Commercial success through significant sales
  - Consumer awareness through advertising and publicity
  - Length of use (5 years may be sufficient for registration purposes)

Enforcement Strategies

- Failure to enforce marks can diminish value
  - If multiple third-parties are using similar marks with the same or related goods, it can narrow the scope of protection afforded to a mark
  - Failure to enforce against a known infringer can prevent you from later enforcing your rights under the doctrines of laches, acquiescence, or estoppel

Enforcement Strategies

- Develop your scope of enforcement
    - Enforce only brewery name or individual product marks?
    - Where will you set your “fences”?
        - How similar must the mark be?
        - How related must the goods or services be?
        - Third-party registration, use, or both?
- Monitoring can be done through third-party watch services or self-monitoring

Enforcement Strategies

- Educate staff regarding documentation of instances of actual confusion
    - Misdirected phone calls, e-mails, etc.
- Before objecting, really consider the **business** case for enforcement
    - How is it harming your business, how could it harm your business in the future?
        - Is there a credible basis for pre- or post-sale confusion?
    - Customize your response based on these facts and issues

Enforcement Strategies

- Trademark Trial and Appeal Board
    - Administrative agency operating similar to federal court, but can only address the right to register a trademark. It cannot issue injunctions or monetary awards.
    - Third-parties can oppose pending applications and cancel some existing registrations
    - Often more time and cost efficient than district court
- Letters of Protest with the USPTO
    - Ex parte petition, effective in limited circumstances
    - May avoid need to oppose a third-party application

Enforcement Strategies

- Business contact sometimes best
    - Letters, phone calls, e-mails, etc.
        - Letters can be ghost written by attorneys where helpful
        - Attorney can also be involved later if escalation required
- Contact potential infringer early
    - Makes it easier (and cheaper) to comply with requests

Enforcement Strategies

- Addressing use of trademarks
  - Plaintiffs: trademark infringement lawsuits
  - Defendants: declaratory judgment actions
  - Attorney fee awards under *Octane Fitness*
    - New, more lenient standard for awards
- UDRP actions for some internet use

Copyright: Brewing Recipes and Processes

- Copyright protects original works of authorship
- Copyright does not protect ideas, procedures, methods, systems, processes, concepts, principles or discoveries
- Copyright does not protect a recipe that is a mere listing of ingredients
- Copyright may extend to a creative explanation of the recipe

Copyright: Brewing Recipes and Processes

- Our Northeast Pale Ale is brewed with Pale and Pilsner malt, along with a copious amount of Citra hops that give a super hazy and juicy color to the beer. Bright oranges fall on the nose with a smooth, citrus flavor on the palate. If you close your eyes, you just might think this beer was juiced rather than brewed."

INSIGHT
MPLS BREWING MADE

Confidentiality and Non-Disclosure Agreements

- Hidden dangers:
  - Proper identification of the parties to the agreement, including the proper legal name of the business entity.
  - Execution of the agreement by an individual with authority to bind the recipient of the confidential information.
  - Proper definition of what constitutes confidential information such that it includes all confidential information that may be disclosed but not so broad that it is unenforceable.
  - Failing to treat confidential information as confidential

Compliance with Other Regulations

- TTB restrictions that affect brand names
  - No misleading names with respect to characteristics of the product
  - No disparagement of competitor brands
  - No “obscene or indecent” designs

THANK YOU!

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Craft Beer, Distillery and Wine Law

Submitted by Jeff O’Brien

A. Brewery and Distillery Business Entity Selection, Formation, Finance, and Insurance

I. Brewing Models

A. Production Brewery

1. Definition: A brewery that brews its own beer onsite and packages its beer for sale largely off-premise. May have a tasting room.

2. Examples of Large Production Breweries: Lagunitas, Bell's, Stone.

B. Brewpub

1. Definition: A brewery whose beer is brewed primarily on the same site from which it is sold to the public, such as a pub or restaurant. If the amount of beer that a brewpub distributes off-site exceeds 75%, it may also be described as a craft or microbrewery. Most brewpubs must adhere to laws which limit the total ratio of beer sales to food sales. A brewpub cannot be considered a bar or beer garden which offers a limited amount of food or limits the restaurant's hours of operation. It must operate as a public restaurant which happens to offer a wide selection of micro-brewed beers.

2. Pros of a Brewpub

a. Brewpubs create marketing to new customers who may not be willing to go to a brewery just to taste beer, but who may be willing to try a new restaurant closer to home.

b. Brewpubs may be located in a more accessible location to attract more people because the brewery is not actually manufacturing beer onsite.

c. Brewpubs can easily develop their own identity by designing the brewpub to reflect their branding and style.

3. Examples of National/Regional Brewpubs: Rock Bottom Brewery, Gordon Biersch, etc.

C. Alternating Proprietorship (AP)

1. Definition: An arrangement in which two or more people take turns using the physical premises of a brewery. Generally, the proprietor of an existing brewery, the "host brewery," agrees to rent space and equipment to a new "tenant brewer." Under this arrangement, tenant brewers are solely responsible for brewing their beer, maintaining all

of the brewing records, labeling the beer using their own name and address, and paying tax on the beer upon their removal of the beer from the brewery.

2. Pros of an Alternating Proprietorship

a. Tenant brewers can develop a brand before they are ready to invest in their own premises and equipment.

b. Tenant brewers can begin placing their product in the stream of commerce to better preserve intellectual property rights.

c. Host breweries can offset their investment by renting out their excess capacity.

d. Host breweries often serve as a buffer to allow for easy transition into a highly-regulated industry.

e. Host breweries take on much of the physical pressure, burden and liability of the brewing operation.

f. Tenant brewer may be eligible for a lower tax rate on beer. Where a brewer produces less than 2,000,000 barrels of beer during a calendar year, there is a reduced tax rate of $7 per barrel on the first 60,000 barrels on beer produced that is also consumed or sold in that same year.

3. Examples of Alternating Proprietorships: 21st Amendment Brewery in CA (Tenant Brewer) within Cold Spring Brewery in MN (Host Brewer), Avery Brewing in CO (Tenant Brewer) within New Belgium Brewing in CO (Host Brewer).

D. Contract Brewing

1. Definition: A business that hires another brewery to produce its beer. It can also be a brewery that hires another brewery to produce additional beer. The contract brewing company handles marketing, sales and distribution of its beer, while generally leaving the brewing and packaging to its producer brewery. The producer brewery provides the recipes for the beer to the contract brewer.

2. Pros of Contract Brewing

a. Producer breweries that cannot supply enough beer to meet demands can contract with a larger brewery to help alleviate their supply issues.

b. Producer breweries do not need to own a brewing facility, so they can avoid the costs associated with a physical brewery.

c. Producer breweries do not need a separate license.

3. Example of Contract Brewing: Gluek Brewing Company in MN (Producer Brewery) within Hard Energy Company in CA (Contract Brewery)

Comparison of Alternating Proprietorship and Contract Brewing Models

Differences	Alternating Proprietorship	Contract Brewing
Title Ownership	Tenant brewer holds title to its beer, including the ingredients and raw materials it uses to produce its beer, during all stages of production.	Contract brewer holds title to the beer, including the ingredients and raw materials used to brew the beer, during all stages of production.
Record Keeping	Tenant brewer and host brewer each retain their own records for production and removal of beer and each provides reports to the Alcohol and Tobacco Tax and Trade Bureau (TTB).	Contract brewer retains all records of production and removal of beer and provides reports to the TTB.
Taxes	Tenant brewer and host brewer are individually responsible for paying their own taxes on their own beer removed from the brewery.	Contract brewer is solely responsible for paying taxes on beer removed from the brewery.
Brewer Licensure	Tenant brewer and host brewer must each qualify as a brewer and have separate licenses.	Only the contract brewer must qualify as a brewer, so the producer brewer does not need a license.
Ease of Paperwork	Requires significant paperwork for both parties.	Simple agreement; Brand is added to the contract brewer's Notice.

II. Entity Selection, Formation and Finance Specific to Breweries and Distilleries

A. LLC vs. Corporation

- A business organization is governed by both the laws of the jurisdiction in which it organizes and the laws of all jurisdictions in which it conducts business. This section is an introduction to the major concepts a brewery or distillery may face upon organization and should not be relied upon for any particular jurisdiction.
- An entrepreneur must first decide under which entity type it will operate. Most likely, the choice will come down to LLC, S-Corp, or C-Corp.
- There are many factors to consider when choosing an entity type, including liability, raising capital and control, and taxation.
-

1. **Limited Liability Company (LLC)**
    a. **Governing Law:** Governed by state statute. The affairs of an LLC are governed predominantly through its various governance documents. The most prevalent governance document is the operating agreement, which defines the rights and duties of the LLC's members.
    b. **Formation:** File articles of organization with the proper state office, typically the Secretary of State. The limited required articles include the name of the LLC, the LLC's in-state address, its organizer(s), the number of membership interests authorized, and the duration it is to exist.
    c. **Management:** Owners are called members. An LLC can have one or more members. The LLC can be member-managed, which means that its members perform the day-to-day management of the company, or it can be manager-managed, wherein managers control the management and governance of the company. In Minnesota, the LLC can also be board-managed, where there are one or more governors who designate officers and managers to act for the LLC who have limited authority granted by the board.
    d. **Capital Contributions:** An LLC can receive capital contributions by any and all of it members, in the form of any consideration, such as money, real property, personal property, or services for the company.

e. **Pass Through Taxation Benefits:** Unless it chooses otherwise, an LLC is taxed as a pass-through entity, which means that the taxation passes through to the LLC members based on the member's individual ownership interest. However, the members are taxed for their ownership interest regardless of whether or not they received any actual distributions in that tax year.
f. **Limited Personal Liability:** Members are not personally liability for the obligations and debts of the LLC beyond their initial capital contributions, provided that corporate formalities are observed by the members.
g. **Newer Form with Flexibility:** Not well-developed set of case law. LLC flexibility often results in a limitation of duties owed to minority owners. However, LLCs can be tailored to meet nearly any situation and are the most widely used business entities currently.

2. **Corporation: C-Corporation and S-Corporation**

a. **Governing Law:** State statutes govern. Most states have well-developed case law to interpret statutes governing corporations. Articles of incorporation, bylaws or shareholder control agreements create and enforce the rights and duties of a corporation's shareholders.
b. **Formation:** Both the S-Corp and C-Corp are separate legal entities formed by a state filing. These documents, typically called the Articles of Incorporation or Certificate of Incorporation, are the same for both S-Corps and C-Corps.
c. **Management Structure:** Both have shareholders, directors and officers. Shareholders are the owners of the company and elect the board of directors, who in turn oversee and direct corporation affairs and decision-making, but are not responsible for day-to-day operations. The directors elect the officers to manage daily business affairs.
d. **Liability Protection:** Shareholders are not personally liable for any debts or obligations beyond the amount of capital they have contributed to the corporation, unless the corporation fails to follow proper corporate formalities.
e. **Corporate Formalities:** Both are required to follow the same internal and external corporate formalities and obligations, such as adopting bylaws, issuing

stock, holding shareholder and director meetings, filing annual reports, and paying annual fees.

f. **Taxation:** Taxation is often considered the most significant difference for small business owners when evaluating S-Corporations versus C-Corporations.

(1) **C-Corporations:** Separately taxable entities. They pay taxes at the corporate level. They also face the possibility of double taxation if corporate income is distributed to business owners as dividends, which are considered personal income. Tax on corporate income is paid first at the corporate level and again at the individual level on dividends.

(2) **S-Corporations:** Pass-through tax entities. They do not pay income, tax at the corporate level. The profits/losses of the business are instead "passed-through" the business and reported on the owners' personal tax returns. Any tax due is paid at the individual level by the owners.

g. Corporate ownership: C-Corporations have no restrictions on ownership, but S-Corporations do. The S-Corporation must meet certain characteristics such as:

(1) it cannot have more than 100 shareholders;

(2) its shareholders must be individuals;

(3) its shareholders must be citizens or residents of the United States;

(4) it must be organized in the United States; and

(5) it can only issue one class of stock.

C-Corporations therefore provide a little more flexibility when starting a business if you plan to grow, expand the ownership or sell your corporation.

B. Tax Considerations

1. LLC: May be taxed as:

a. a disregarded entity if it has one member. The member experiences complete pass through taxation. The member gets taxed on all profits based on tax bracket, whether distributed or not; or

b. a partnership if it has multiple members. The members experience complete pass through taxation. The members get taxed on all profits based on their tax bracket and ownership interest, whether distributed or not; or

c. it may elect to be taxed as a corporation. The members experience incomplete pass through taxation, which allows the company to retain earnings from year to year and avoid being taxed regardless of a distribution.

2. **Corporation**
    - **a.** C-Corporation; Double Taxation: Taxed at the entity level as well as shareholder level, who each get taxed individually for any distributions received from the corporation.
    - **b.** S-Corporation; Pass Through Taxation: Shareholders are only taxed individually.

C. Structuring, Management and Governance

1. **Management**
    - **a.** LLC/Corporation: States may require an LLC or corporation to have certain designated officers for assist in the company's day-to-day operations. These officer positions may be held by one or more of the company's owners, but can also be held by a non-owner. Officer positions will also often have statutorily-defined duties that can be general to each officer or specific to a particular position, but can be altered with approval of the members or shareholders through agreements. The officers must carry out their duties in the best interests of the company and its owners.
        - **i. LLC:** Can be managed by its members, designated managers, or board of governors. Managers and members of the board of governors can be, but are not required to be, members of the LLC. The individuals responsible for the management of the LLC may also delegate their authority to officers, such as the president, vice president, secretary, or treasurer.
        - **ii. Corporation:** Typically, management is vested in the board of directors. The board of directors serve the interests of the shareholders.
            - Closely Held Corporation: Generally, the shareholders will serve on the board.
2. **Fiduciary Duties**: Individuals responsible for management and operations of a company are generally required to adhere to the duty of care, duty of loyalty, and duty of good

faith in discharging their duties on behalf of the company. If such individuals fail to perform these duties, they may be liable to the company and its owners.

a. **Duty of Care:** A legal obligation which is imposed on an individual requiring adherence to a standard of reasonable care while performing any acts that could foreseeably harm others.
b. **Duty of Loyalty:** A legal obligation which requires fiduciaries to put the corporation's interests ahead of their own. Corporate fiduciaries breach their duty of loyalty when they divert corporate assets, opportunities, or information for personal gain.
c. **Duty of Good Faith:** A general presumption that the parties to a contract will deal with each other honestly, fairly, and in good faith, so as to not destroy the right of the other party or parties to receive the benefits of the contract. It is implied in every contract in order to reinforce the express covenants or promises of the contract.

3. **Corporate Formalities for LLC/Corporation:** Must observe certain formalities in order to maintain the limited liability shield extended to its members/shareholders .

- Piercing the Corporate Veil: The legal standard for extending personal liability varies by state, but the following suggestions help maintain the limited liability shield after forming a limited liability entity:

a. Ensure the entity is sufficiently capitalized;
b. Document any payments to the legal entity from the owners as either paid-in-capital or loans;
c. Do not commingle personal and business funds;
d. Do not pay owners in cash;
e. Owners should never use the business's cash or assets for personal use or pay personal bills with company funds;
f. All of the entity's taxable income should be reported on the entity's tax returns and tax returns should be filed promptly;
g. Shareholders who are actively involved in the business should receive a "reasonable" pre-determined wage or salary for their services;

h. All payments to shareholders should be clearly documented as being wages, expense reimbursements, or profit distributions;

i. All expenses paid to shareholders should be reflected in formal expense reimbursement reports, backed up by appropriate receipts and invoices;

j. Owners should not receive "profit distributions" if the entity is insolvent;

k. All creditors should be paid regularly before distributing any profits;

l. Any purchase of property, computers, equipment, etc. from shareholders should be at commercially reasonable prices and terms and documented in formal written agreement;

m. Obtain appropriate insurance for the type of business in question;

n. Prepare appropriate bylaws, operating agreements, etc.;

o. Hold annual meeting of directors, shareholder, or members and prepare the minutes in a corporate minute book, which should reflect major corporate transactions;

p. Hold elections and appoint officers and directors for the entity;

q. Obtain federal and state tax identification numbers;

r. Obtain sales tax exemption certificates;

s. Issue share certificates to owners (if corporation);

t. File annual registration statement with Secretary of State to remain in "good standing" if the state law requires it;

u. Sign all contracts, agreements, purchases, plans, loan, investments, and accounts in the name of and on behalf of the entity;

v. Train officers and directors how to sign contracts, purchase orders, and agreements on behalf of the entity;

w. Register all "assumed names" being used by the entity;

x. Use the official corporate name on all letterhead, business cards, marketing materials, coupons, websites, etc. to clearly notify third parties that the business has limited liability;

y. If possible, run the business profitably and pay dividends/profit distributions to the owners periodically; document the same;

z. Avoid entering into transactions or incurring debts when the company is insolvent;

aa. Avoid having the dominant owner siphon funds from the business;

bb. Ensure that all officers and directors have a meaningful voice in the business, participate in decision-making, and periodically meet and vote on major corporate decisions;

cc. Avoid using the corporation merely as a façade for individual dealings.

D. Drafting and Negotiating Formation Agreements

1. General Governance Documents

a. Drafting formation agreements is very important for memorializing the rights, responsibilities, and expectations of a business's owners, officers, managers, or board members.

b. 'Governance documents often expressly provide provisions regarding the decision-making process, profit and loss allocations and distributions, fiduciary duties, conduct and procedures for meetings, and delegation of officer positions and duties.

c. A few examples of agreements: operating, member control, partnership, shareholder control, buy-sell, bylaws.

2. Additional Brewery/Distillery Provisions

a. Include provisions that require all proposed members, shareholders, directors or officers to pass the appropriate TTB background check process.

b. Include provisions that require all proposed members, shareholders, directors or officers to pass any applicable local requirements to obtain and hold a liquor license or any other relevant local licensing requirements.

i. Include provisions that require the ownership in the business to be subject to maintaining or passing any required local licensing.

ii. If the owner does not meet these standards or fails to maintain these stands, the governance documents can establish procedures to terminate

the relationship with the individual, including a forced buy-out of the owner's interest in the company.

E. Capital Raising, Crowdfunding, and Other Financing Methods

1. Current Regulatory Landscape and Key Definitions

a. Generally: Nearly every means by which a company raises capital involves securities laws. These laws regulate the manner in which securities are sold, the amount of money that may be raised, the persons to whom the securities may be offered, and the method by which investors may be solicited.

b. Federal Registrations and Exemptions: As a general rule, in order to comply with Federal securities laws, a person selling a security must either:

i. "register" such sale with the Securities Exchange Commission (SEC) or

ii. identify a specific exemption that allows such sale to be conducted without registration.

- SEC registration is time consuming and expensive.
- For most small businesses, SEC registration is not a feasible option.

c. State Blue Sky Laws: In addition, an issuer selling securities must adhere to blue sky laws in each state where the securities are being sold, all of which vary from each other.

2. Private Placements

a. Section 4(2): The most common federal exemption entrepreneurs rely on is Section 4(2) of the Securities Act, which exempts "transactions...not involving any public offering" - i.e., a **private placement**. A company seeking to determine whether an offering will be exempt from registration under Section 4(2) will need to evaluate a number of factors which, although routinely addressed by courts, seldom lead to a definitive answer as to whether an offering is a "public offering" under Section 4(2). Different courts emphasize different factors critical to the Section 4(2) exemption, no single one of which necessarily controls. The factors are guidelines, and include:

i. Offeree qualification (i.e., whether the investors are sophisticated);

ii. Manner of the offering (i.e., whether the company will engage in advertising or other promotional activities);

iii. Availability and accuracy of information given to offerees and purchasers (i.e., whether the people to whom the company proposes to sell securities have access to basic financial information about the company);

iv. The number of offerings and number of purchasers (i.e., whether the company solicited investment from a large group of people); and;

v. Absence of intent to redistribute (i.e., whether the people to whom the company proposes to sell securities have an intention to hold the securities for investment purposes - generally for a minimum holding period of 24 months).

b. Regulation D: The SEC provides a clear set of "safe harbor" rules that issuers can follow to ensure that they are conducting a valid private placement under Section 4(2). The most common safe harbors that small companies have customarily relied upon in conducting private placements are Rule 504 and Rule 506 (now called Rule 506(b) - see below).

i. General Solicitation: Rule 502(c) provides that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

1. any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

2. any seminar or meeting whose attendees have been invited by any general solicitation or advertising." In general, this means that issuers will need to have a substantial pre-existing relationship with a potential investor before making an offer of securities under Rule 504 or Rule 506(b).

ii. Accredited investor: Under Rule 501(a), an accredited investor is a person who meets certain qualifications and, therefore, is deemed able to protect himself or herself in making investment decisions without

additional protections under the securities laws, such as those obtained through the SEC registration process and the public disclosure of information about the company that is made through the process of becoming an SEC reporting company. There are several ways to qualify as an accredited investor with the most common being:

1. an individual with at least $200,000 (or $300,000 jointly with a spouse) in annual income over the past 2 years or at least $1 million in net worth (excluding the value of a principal residence); or
2. an entity in which all of the equity owners are accredited investors or the entity has at least $5 million in net assets.

3. The "Old Rules" For Raising Capital

a. **Rule 504:** Generally speaking, Rule 504 allows companies to raise up to $1 million from an unlimited number of accredited and non-accredited investors (subject to counterpart state Blue Sky registrations and exemptions). Companies are not permitted to engage is general solicitation except for in states where the securities have been registered or states that provide an exemption from registration that allows the company to generally solicit to accredited investors only.

   i. **State law counterpart:**- Limited Offering Exemption: Most states have a "limited offering" exemption that is often relied on by companies who are conducting Rule 504 offerings. Normally, sales by a company to no more than 35 non-accredited investors (and an unlimited number of accredited investors) during any 12 consecutive months are exempt from registration.

b. **Rule 506:** Rule 506 is the most common "safe harbor" relied on by companies conducting private placements. Generally speaking, Rule 506 allows an issuer to raise an unlimited amount of capital from an unlimited number of accredited investors and up to 35 non-accredited investors. However, if even one non-accredited investor becomes a purchaser in the offering, then the company must provide all investors with a very detailed disclosure document that satisfies other

SEC requirements. For this reason, the practical reality is that Rule 506 offerings are usually restricted to accredited investors only.

i. **State law counterpart:** Securities issued in reliance on Rule 506 are considered Federal "covered securities" and the offer and sale of such securities are exempt from registration as long as the issuer makes a notice filing.

ii.

4. **The "New" Rules:** Jumpstart Our Business Startups (JOBS) Act: On April 5, 2012, Congress passed the JOBS Act in an effort to foster job growth by modernizing Federal securities laws. The JOBS Act consisted of three key parts that are relevant for securities crowdfunding:

Title II	Title III	Title IV
Advertising in Connection with Sales to Accredited Investors	**Crowdfunding for All**	**Reg A+/"Mini-IPOs"**
Also called Rule 506(c)	SEC released proposed rules in October 2013	SEC released final rules in March 2015
Became effective in October 2013	The proposed rules have been almost universally criticized	Became effective in June 2015
Growing in popularity	Revised rules went into effect in May 2016	Not very useful for small businesses

a. **Title II and Rule 506(c) - Advertising to Accredited Investors:** In late 2013, the SEC (pursuant to the authority granted to it under Title II of the JOBS Act), finalized new Rule 506(c) which allows companies to generally solicit (or advertise) their securities offerings so long as all of the investors who actually purchase securities in the offer are accredited. This means that companies may now talk about their offerings in public seminars, send out email blasts, push offering information out on social media sites, as well as run ads on TV, radio,

and the Internet. Companies who comply with Rule 506(c) are now free to talk about their offering to whomever they want (including non-accredited investors). Companies who generally solicit under Rule 506(c) may only sell the securities to accredited investors.

(1) Verification Steps: Using Rule 506(c), however, comes with certain additional compliance requirements. Companies must take additional steps to verify that all purchasers actually are accredited. In Rule 506(c), the SEC listed several non-exclusive methods that are deemed to satisfy the verification requirements (provided that the issuer does not have knowledge that the purchaser is non-accredited). The "safe harbors" include:

(i) Income verification by checking federal tax forms, including W-2's and tax returns, and a statement by the investor that he or she expects enough income in the current year to remain accredited;

(ii) Net worth verification by checking a recent credit report (with the past 3 months) and bank or investment account statements, together with a written representation from the purchaser that he or she has disclosed all liabilities necessary to make a determination of net worth; and

(iii) Certification of accredited investor status by a registered broker-dealer, SEC-registered investment advisor, licensed attorney, or CPA who has verified the purchaser's accredited investor status.

Comparison of Rules 504, 506(b) and 506(c)

	Rule 504	Rule 506(b)	Rule 506(c()
How much money can I raise?	Up to $1M	Unlimited	Unlimited
Can I advertise the sale of my securities?	No, unless coupled with a state exemption or registration that allows advertising.	No, unless coupled with a state exemption or registration that allows advertising.	Yes.
To whom can I sell	Anyone.	Unlimited number of	Unlimited number of

securities?	However, counterpart state exemptions or registrations may impose additional restriction on number to non-accredited investors	accredited investors. Up to 35 non-accredited investors if you believe they are "sophisticated".	accredited investors
Do I have to comply with SEC's formal information delivery requirements?	No, but counterpart state exemption or registration may impose additional requirements.	No, if only accredited investors are included. Yes, if any non-accredited investors are included.	No.
Do I have to verify that any accredited investors are truly accredited?	No, accredited investors can "self-certify".	No, accredited investors can "self-certify".	Yes, you must take "reasonable steps" to verify that the investors are, in fact, accredited.

b. Title III "retail" crowdfunding and Regulation CF: Title III of the JOBS Act was meant to democratize the business funding process by allowing non-accredited individuals the opportunity to participate online and invest into private companies. The SEC delayed releasing final rules for years, and the system finally went live in May 2016. Issuers must comply with multiple requirements and limitations, namely:

- Issuer may only raise up to $1M in any 12-month period.
- Individual investor limits:
    - If the investor's annual net income OR net worth is < $100k, then the investor may invest the greater of: (a) $2,000; or (b) 5% of the investor's annual income or net worth.

    - If the investor's annual net income AND net worth is > $100k, then the investor may invest 10% of the investor's annual income or net worth
- Investors are subject to a $100k max across all Reg CF offerings in any 12-month period.
- Issuer must provide financial statements based on offering size:
    - < $100k -› Internally prepared, certified statements
    - $100k - $500k 4 CPA reviewed statements
    - $500k - $1M -› CPA audited financials (or CPA reviewed statements if the issuer is a first time user of the system).
- Issuer must file a robust disclosure document with the SEC.
- Issuer is subject to annual SEC reporting obligations.
- Offerings must be made through registered portals. The portals must be either (a) registered with the SEC as a broker-dealer; or (b) registered as a portal operator with the SEC and be a member of FINRA.

c. **Title IV and Regulation A+:** Reg A+, which went into effect in June 2015, has been described as a mini-IPO or "IPO-Lite," in that it allows nearly any company with principal offices in the U.S. or Canada to use internet crowdfunding to raise up to $50 million per year from any number of both accredited and non-accredited investors under a regulatory scheme that is far less burdensome than that of a traditional IPO. There is no prohibition on general solicitation, and offering companies are not required to independently verify the sophistication (income or net worth) of their investors. Corporations, limited liability companies, and limited partnerships can take advantage of Reg A+'s two-tiered offering scheme and can sell nearly all types of securities, including equity, debt, and debt securities convertible into equity securities. Furthermore, the securities issued in Reg A+ will be unrestricted and freely transferable. One of the most exciting changes for companies seeking to raise capital under Reg A+ is that Tier 2 offerings are not subject to state Blue Sky registration and merit review (further explained below).

a. **Tier 1:** Tier 1 offerings are largely similar to old Regulation A offerings, but the old limit of $5 million raised in a 12-month period per issuer has now been increased to $20 million. Unlike Tier 2, there is no limit on the amount a non-accredited investor may invest in any Tier 1 offering.
    i. State Registration: Tier 1 still requires that offerors register under the Blue Sky laws of every state in which money is raised. However, the NASAA (North American Securities Administrators Association) recently launched a multi-state coordinated review program for Regulation A offerings that, if successful, would allow an issuer to register with multiple states by filing just one package with a relatively quick turnaround time. This could make Tier 1 much more attractive for many issuers, given its lower cost.
    ii. **Reporting:** Tier 1 is less burdensome than Tier 2 in terms of SEC requirements for initial filing and ongoing reporting. Tier 1 does not require audited financial statements nor ongoing reporting. The only requirement is that offering companies file a Form 1-Z to report the completion of their offering.
b. **Tier 2:** Under Tier 2, companies are allowed to raise up to $50 million in a 12-month period and, most importantly, there is no requirement that the offering company register under any state Blue Sky laws because the federal Reg A+ preempts state law. Tier 2 offerings must only be registered with and approved by the SEC. On the other hand, Tier 2 limits investment by non-accredited investors to the greater of 10% of their annual income or net worth, excluding their primary residence, per offering. Tier 2 also includes substantially more onerous reporting requirements than Tier 1.
    i. **Audited Financial Statements:** Tier 2 issuers must provide the SEC with two years of audited financial statements before approval, while Tier 1 issuers only need to provide "reviewed" statements.

ii. **Ongoing Reporting:** After a successful Tier 2 raise, Tier 2 issuers who have 300 or more record holders of the security offered must also file the following ongoing reports:

1. Detailed annual reports, using Form 1-K;
2. Semiannual reports, using Form 1-SA, including unaudited interim financial statements and a management discussion; and
3. Current event reports, using Form 1-U, reporting all fundamental changes.

Comparison of Rule 506(c), Reg CR and Reg A+

	Title II **Rule 506(c)**	**Title III** **Reg CR**	**Regulation A+** **Tier 1**	**Regulation A+** **Tier 2**
Maximum Dollars Raised	No maximum	$1 million per 12 months, including affiliates	$20 million per 12months	$50 million per 12 months
Permitted Investors	Only Accredited	Anyone	Anyone	Anyone
Per-Investor Limits	None	Yes-depends on income and net worth of investor, and applies to all Reg CF deals per year.	None	For non-accredited investors, 10% of income or net worth whichever is more, per deal
General Solicitation (Advertising) Permitted?	Yes	Yes, but only through portal	Yes	Yes
Testing the Waters Permitted	Yes	Yes	Yes	Yes
Securities Sold Through Third Party	Yes (but not required)	Yes (required)	Yes (but not required)	Yes (but not required)

	Title II **Rule 506(c)**	**Title III** **Reg CR**	**Regulation A+** **Tier 1**	**Regulation A+** **Tier 2**
Portal?				
Can Issuer Run Its Own Portal?	Yes	No	Yes	Yes
Pre-Sale Information Required	Moderate	Substantial	Very substantial, akin to a registration statement for a public company.	Very substantial, akin to a registration statement for public company.
Audited/Reviewed Financial Statements Required?	No	Depends on size of offering; most first time users will have to provide reviewed statements.	No	Yes
Pre-Sale Approval Required	No	No	Yes-submission must be approved by SEC and the states where the securities will be sold (through a coordinated review).	Yes-Submission must be approved by SEC; state approval not required.
Investor Verification	Verification required	Self-certification	N/A	Self-certification
Ongoing Reporting	None	Moderate	None	Substantial ongoing reporting, akin to a min-public company, but waived depending on number of investors.
Length of Process	Fast	Moderate	Very Slow	Very Slow

5. Other Crowdfunding Methods

a. **Rule 504 + State registration:** Theoretically, a company may legally conduct a small (less than $1 million) crowdfunding campaign by combing a Federal Rule 504 exemption with state registered offering.
    i. **General Solicitation under Rule 504:** Rule 504 allows an issuer to engage in general solicitation to accredited and non-accredited investors if the issuer either:
        1. Registers the offering exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors; or
        2. Registers and sells the offering in a state that requires registration and disclosure delivery and also sells in a state without those requirements, so long as the company delivers the disclosure documents required by the state where the company registered the offering to all purchasers (including those in the state that has no such requirements).
    ii. **SCOR Offering Option:** Some states provide a simplified process for "small corporate offering registrations" that otherwise are exempt from Federal registration under Rule 504.
b. **Federal intrastate exemption + State crowdfunding exemption**
    i. **Section 3(a)(11) and Rule 147:** Another lesser known Federal securities exemption is the "intrastate" exemption embodied by Section 3(a)(11) of the Securities Act and Rule 147 promulgated by the SEC. Generally speaking, Section 3(a)(11) exempts from SEC registration any offering that is confined to the borders of a single state. To qualify for this exemption, the company must meet requirements of Rule 147, which include:
        1. The company must be incorporated in the state in which it is offering the securities;
    ii. The company must only sell the securities to individuals residing in that state;

iii. 80% of the company's consolidated gross revenues must be derived from the state in which the offering is conducted;

iv. 80% of the company's consolidated assets must be located within the state in which the offering is conducted; and

v. 80% of the offering's net proceeds must be intended to be used, and actually used, in connection with the operation of a business or real property, the purchase of real property located in, or the rendering of services, within the state in which the offering is conducted.

In addition to complying with the Federal "intrastate" exemption, the issuer must also satisfy the requirements of the state crowdfunding exemption. The requirements vary on a state-by-state basis, but they often impose:

i. Limits on the amount of money the issuer can raise;

ii. Limits on the amount of money that investors can invest (there are usually different limits for accredited investors vs. non-accredited investors);

iii. Disclosure requirements, including whether the issuer must provide purchasers with audited or reviewed financial statements;

iv. Escrow requirements;

v. Use of third party Internet portal; and

vi. Ongoing reporting requirements of the issuer.

c. General Solicitation in Intrastate Crowdfunding Offerings: There is no prohibition in Section 3(a)(11) or Rule 147 regarding general solicitation as long as such solicitation:

- complies with applicable state law; and
- does not result in an offer or sale to nonresidents of such state.

i. **SEC Guidance on Online Advertising:** In recent months, the SEC has provided guidance on how intrastate issuers can use the internet to publicize their offerings without having those online advertisements result in an offer or sale to nonresidents of that state.

a. **Limiting Access to Out of State Residents:** In April 2014, the SEC clarified in Questions 141.03-141.05 that issuers hoping to utilize the Rule

147 exemption could use the Internet for general advertising and solicitation if they implemented measures to limit the offers to people within the issuer's state. In the context of an offering conducted within state crowdfunding requirements, those measures have to include:

i. limiting access to information about a specific investment opportunity to persons who confirm they are residents of the relevant state "(for example, by providing a representation...such as a zip code or residence address)" and

ii. providing a disclaimer and restrictive legend clarifying "that the offer is limited to residents of the relevant state under applicable law." (Question 141.04).

b. **IP Address Blocking:** In recent years, the SEC suggested what might be a simpler method of limiting the offer to those within the relevant state. The issuer can "implement technological measures" that limit any offers to persons with an IP address originating within the issuer's state and prevent offers to any individuals outside of the issuer's state (Question 141.05). However, the offer should still contain a disclaimer and restrictive legend. Presumably, this clarification allows issuers to skip the opt-in step where the viewer must verify they are residents of the relevant state before viewing the solicitation or advertisement. The simplification could greatly increase the number of views and potentially improve the effectiveness of the communication.

6. **Capital Raising Pitfalls**

a. **Rights of Ownership:** When considering whether to engage in a private offering to raise investment capital, a company must consider that investors will be owners of the company following the offering (albeit likely constituting a minority stake in the entity) and as, such, those investors will have certain rights afforded to them by law.

b. **Limited Liability Companies**

i. **Governance Rights:** A member's governance rights (i.e., the right to vote and control) in a limited liability company (LLC) depends upon whether

the LLC is member-managed, board-managed or manager-managed. If the LLC is member-managed, each member has equal rights in the management and conduct of the company's activities. Even if the LLC is manager-managed, certain proposed actions require consent of the members. In a board-managed LLC, while the board of governors manages the LLC's affairs, the board is selected by a majority vote of the members.

ii. **Right to Profits:** Unless otherwise provided in the LLC operating agreement, each member is entitled to participate in any distribution(s) of the company's profits (although as noted herein, some additional incentives may be necessary).

iii. **Right to Information:** Members have the right to access information from the LLC that is material to the member's interest as a member.

iv. **Minority Rights Regarding Oppressive Conduct:** A member does not have the right to dissent from a proposed course of action and require the LLC to purchase his/her membership interest. However, some states provide for certain rights and remedies upon a court finding of "oppressive conduct" towards a minority member or members. Note, however, that the LLC operating agreement can limit the remedies that a court may impose, including but not limited to a court-ordered buyout.

c. Corporations

i. **Voting Rights:** Unless otherwise provided within the corporation's articles of incorporation, a shareholder in a corporation has one vote per share. In addition, even if the articles provide that the holders of a particular class of shares are not entitled to voting rights, in some instances, these shareholders are entitled to voting rights as a matter of law.

ii. **Rights to Information:** Shareholders are entitled to inspect books and certain records of the corporation.

iii. **Dissenters Rights:** Most significantly, a shareholder of a corporation may dissent from, and obtain payment for the fair value of the shareholder's shares in the event of certain actions.

d. **Maintaining Control:** Frequently in private offerings for startup ventures, the capital contributed by investors through the offering often exceeds the amount of capital contributed by the company's founders. This can prove problematic for the founders seeking to maintain control of the entity by offering a minority ownership stake in the company through the offering. However, various incentives can be employed to make ownership of a minority interest in the business more palatable for investors.

e. **Changes to Terms of Offering; Rescission Offers:** Frequently a prospective investor will propose a counteroffer which differs from the terms outlined in the offering document. If accepted, be aware that changed terms for even a single investor will trigger an obligation to make a rescission offer to prior investors.

7. **Other Sources of Funds**

a. **Debt Financing:** Before embarking upon a private offering, it is best to consult with one or more lending institutions regarding a small business loan. Banks offer several small business loan programs, ranging from their own private loan programs to those loan programs established by the U.S. Small Business Administration (SBA). These types of programs are particularly useful when seeking financing to acquire equipment and/or real estate, given the ability to pledge these assets as collateral. Personal guaranties of those owners holding 20% or more is also generally required.

b. **"Gap" Financing:** "Gap" financing refers to state and local financing incentives that can bridge the gap between a bank loan and an equity capital investment.

i. **State Initiatives:** Some states have financing programs available for small businesses. These initiatives provide financing to help add new workers and retain high-quality jobs on a statewide basis. The focus is usually on industrial, manufacturing, and technology-related industries to increase the local and state tax base and improve economic vitality statewide.

ii. **Local Financing Incentives:** Some cities have financing programs and incentives available for small businesses that locate within those cities. For example, some cities have a "Two-Percent Loan" program. Two-Percent Loans provide financing to small businesses (retail, service or light manufacturing) to purchase equipment and/or to make building improvements. A private lender provides half the loan at market rate and the City provides the rest, up to $50,000 at 2 percent interest (up to $75,000 in designated neighborhood commercial districts). The loan term is set by the private lender and can be for up to 10 years. Bank fees vary, but the City charges a 1 percent origination fee with a minimum of $150 due at closing.

iii. **Tax Increment Financing:** Tax increment financing, or TIF, is a public financing method that is used as a subsidy for redevelopment, infrastructure, and other community-improvement projects. Through the use of TIF, municipalities can dedicate future tax revenues of a "particular business or group of businesses toward an economic development project in the community.

c. **Kickstarter/Rewards Based Crowdfunding:** In recent years, websites such as Kickstarter.com have popularized "rewards-based" crowdfunding. Kickstarter.com is a web portal that allows individuals to make a contribution to a particular project in exchange for some reward, typically some type of tangible product. Other variations of rewards-based crowdfunding include "founders clubs" (often used by local breweries and distilleries) which offer a variety of member benefits (but not any voting rights or share of profits in the enterprise so as to steer clear of the definition of a "security") in exchange for payment of a one-time membership fee. These types of rewards-based incentives should be structured in a way that minimizes liability for the company; i.e., the terms and conditions of membership should be in writing and should specify what happens to the memberships if the company is sold or ceases to do business, that the memberships are non-transferrable and that the membership does not carry with it the rights of ownership.

8. **Practical Considerations in Structuring a Private Offering**

   a. **Put Rights:** A put or put option is a device which gives the owner of the put the right, but not the obligation, to sell his/her shares, at a specified price (the put price), by a pre-determined date to a given party (typically the company).

   b. **Call Rights:** In contrast to put rights, call rights or a call option refers to the right, but not the obligation, to buy an agreed number of shares within a certain time for a certain price (the "call price"). The seller is obligated to sell his/her shares to the buyer if the buyer so decides.

   c. **Preferred Distributions:** In some instances, it may be necessary or advantageous to incentivize potential investors by including a preferred distribution for investors. Most closely held companies give their board the discretion to make (or not make) distributions of profits and the amount of such distributions. A preferred distribution constitutes the company's contractual obligation to pay a minimum amount to the holders of such preferred distribution rights ahead of making any discretionary distributions to all owners. Often times preferred distributions are "cumulative", meaning that a preferred distribution which is not made in one year cumulates and is to be paid when the company has funds available to pay it.

   d. **Preferential/Accelerated Distributions:** In regards to general distributions of profits, in order to maintain governing control of the company following a private offering, and in addition or alternative to preferred distributions it may be necessary to offer investors a distribution preference. For example, suppose the investors as a group own 40% of the company. A distribution preference would be to make 60% of the company's operating distributions to the investor class for a period of years until the investors recoup their initial investment. Upon doing so, distributions would then be made pro rata based upon ownership percentages.

   e. Written Agreement. All of these mechanisms should be included in a written agreement between the owners (an operating agreement for an LLC or a shareholder agreement for a corporation), and new investors should be required to execute a joinder to the agreement in order to bind themselves to the agreement.

B. Local, State, and Federal Registration, Permits, Regulations

C. Labeling and Regulatory Compliance

The Regulatory Framework at the Local, State and Federal Levels

A. Federal

i. Alcohol and Tabaco Tax and Trade Bureau (TBB)

a) The Alcohol and Tobacco Tax and Trade Bureau (TTB) regulates craft beer at the federal level. (Brew Law 101 at 59).

b) Anyone brewing beer for sale must obtain a Brewer's Notice from the TTB. You can find the form online at their website but be aware the process can take on average 129 days. *Id.*

c) The application requires a heavy amount of paperwork, including personal information for every officer, director, and shareholder who holds at least 10% interest in the company. *Id.*

ii. Food and Drug Administration (FDA)

a) Federally regulates any "facility that manufactures, processes, packs, or holds food or beverages – including alcoholic beverages – for consumption in the United States." *Id* at 60.

b) You must register with the FDA biannually, but there is no fee involved. *Id.*

B. State

i. Need to register with the Secretary of State to obtain a tax ID.

ii. If you are 10 of more days late in filing or paying your taxes, you will be placed on the public Tax Delinquency Liquor Posting List. Being on this list means that no wholesaler, manufacturer, or brewer can sell or deliver any product to you. You cannot purchase beverages for resale if you are on the list. The state also has the power to revoke or deny a renewal of license.

iii. Wholesaler/Manufacturer's Intoxicating Liquor License

a) In Minnesota, a brewery must obtain this license. This license must be renewed annually. Takes 30 days to process and can cost anywhere from $20 - $15,000 depending on the type of facility or license.

b) Requirements:

1. $10,000 Surety Bond;

2. Be at least 21 years old;

3. Has not had a licensed issued under Minn. Stat. § 340A revoked within the past years; and

4. Not been convicted of a felony within the past 5 years or any willful violation of federal, state, or local ordinances governing the manufacture, sale, distribution, or possession for sale of distribution of alcoholic beverages.

C. Local

a) Growlers

b) Tape Rooms/ Cocktail Rooms

State and Federal Registration Requirements

A. State-Level Registration

i. State Licensing Issues

a) While the TTB's licensing requirements and regulations apply for breweries and distilleries in any state within the U.S., state and local laws vary by jurisdiction.

ii. Top Permitting/Licensing Issues

b) First and foremost, it is imperative to understand what permits and licenses must be obtained at each level of government before operations can legally begin.

c) At the Federal level, when you are seeking a brewer's notice or distilled spirits plant license, be sure that your application is complete and accurate, as incomplete applications will not be reviewed and will ultimately be dismissed.

d) At the state level, be aware of which agency or agencies are responsible for reviewing your application and provide such agency/agencies with all required and requested documentation in order to ensure expeditious review and approval.

e) It is also imperative to understand what local requirements exist as to the brewery or distillery, be they taproom/cocktail room licenses or other issues (such as growler sales restrictions and/or garden variety land use/zoning requirements).

D. Navigating TTB Labeling Regulations – and Landmines to Avoid!

i. **TTB:** At the federal level, breweries and distilleries are regulated via the Alcohol Tobacco Tax and Trade Bureau, an agency falling under the U.S. Department of Treasury. Commonly referred to as the "TTB", this agency grew out of the Bureau of Alcohol, Tobacco, Firearms and Explosives ("ATF") in 2003. The TTB handles all federal liquor law issues including tax revenues, permits, licenses, tax audits, trade investigation and labels.

ii. Navigating Local, State and Federal Rules, Regulations and Requirements: While the TTB's licensing requirements and regulations apply for breweries and distilleries in any state within the U.S., state and local laws vary by jurisdiction.

iii. State and Federal, TTB Registration Requirements

a. <u>Federal</u>

1. The TTB requires anyone brewing beer for sale to acquire a Brewer's Notice. Historically, the process for obtaining a Brewer's Notice through the TTB was time consuming, but with the recent craft brewing and distilling boom, the TTB has streamlined the process through its Permits Online site, https://www.ttbonline.gov/permitsonline.

2. Information and documents to be submitted to the TTB in connection with the Brewer's Notice application include the following:

- Articles of Organization (LLC) / Articles of Incorporation Corp.)
- Operating Agreement (LLC) / By Laws (Corp.)
- Federal EIN (from IRS)
- Owner Officer Questionnaires (for each owner of 10%+ and each officer)
- List of all owners and officers identifying percentage of voting ownership, amount of funds invested, etc. (if owner is an entity, EIN)
- Source of Funds Documents (bank statements, loan documents, etc.)
- Diagram of Premises
- Description of Property (usually metes & bounds is best)
- Description of Equipment (more reviewers are requiring this, at least provide size of tanks)
- Description of the Building (walkthrough of the brewery premises)
- Environmental Questionnaire (number of employees, amount of waste, disposal of liquid and solid waste, electric/gas provider name, etc.)

- Supplemental (disposal of waste into navigable waterways, etc.)
- Brewer's Bond
- Consent of Surety (if using a non-contiguous warehouse, alternating premises between a brewery and a distillery, running an alternating proprietorship, etc.)
- Lease agreement or mortgage (with permission to use premises as a brewery/distillery)
- Assumed name registration (if applicable)
- Security statement
- Designation of a main contact person
- Copy of ID for main contact person
- Signing authority resolution for application contact
- TTB's Signing Authority Form
- Power of attorney (if being filed by an attorney)
- Other (historic buildings, variance request, etc.

3. Similarly, anyone seeking to produce distilled spirits must obtain a distilled spirits plant license through the TTB with similar requirements as for the Brewer's Notice.

b. <u>State Licensing Issues</u>

i. While the TTB's licensing requirements and regulations apply for breweries and distilleries in any state within the U.S., state and local laws vary by jurisdiction.

c. Formula Approvals

i. <u>Beer Formulas</u>

1. Beers do not typically require a formula approval, unless they contain a non-traditional beer ingredient or are made using a non-traditional brewing method.

2. In 2015, TTB issued a ruling broadly expanding the definition of "traditional." Under the new rule, traditional ingredients and processes have been expanded, and are listed in the attachment on the next page.

3. If the beer includes a "non-traditional" fruit, spice (e.g., elderberry), or "sweetener" (e.g., aspartame), or contains a coloring (e.g., Blue No. 1), flavoring (e.g., an extract), or TTB limited ingredient (e.g., calcium chloride), or is made by a "non-traditional" process (e.g., "ice distilling"), the beer requires a TTB formula approval before TTB

will issue a COLA approval. For more information on ingredient issues, see Appendix 1.

ii. Spirits formulas

1. Most traditional spirits do not require a formula approval, unless they contain a restricted product (e.g., thujone), or are infused with flavors or colored. Occasionally, a product must also be sent in to TTB's lab for analysis. Lab analysis is more typically required for imported products to make sure certain requirements are met. TTB's chart is attached hereto as Appendix 2, which shows if/when formula and/or laboratory approval is required for a distilled spirits product prior to label submission.

iii. Labeling

1. Another integral responsibility of the TTB is to regulate and approve labels for packaging beer and spirits. Section 105(e) of the Federal Alcohol Administration Act (27 USC 205(e)) authorizes the Secretary of the Treasury to issue regulations regarding product labeling that:

- (1) ensure that consumers are provided with adequate information as to the identity and quality of alcohol beverages, and

- (2) prevent consumer deception. The Secretary has delegated to the Alcohol and Tobacco Tax and Trade Bureau (TTB) authority to administer the regulations promulgated under section 105(e). Section 105(e) and the TTB regulations require a Certificate of Label Approval ("COLA") for each alcohol beverage product regulated by the agency. TTB issues COLAs on TTB Form 5100.31.

2. First, you must register for the COLA's. Appendix 3 contains instructions on how to successfully register using the online system. If you choose not to file electronically, you must TTB Form 5100.3, in duplicate form, to the following address:

Advertising, Labeling and Formulation Division
Alcohol and Tobacco Tax and Trade Bureau
1310 G Street, NW, Box 12
Washington, DC 20005

3. A copy of Form 5100.3 is included at Appendix 4.

4. NOTE: You must obtain label approval prior to bottling if you are shipping out of state.

5. For many alcohol beverage products, TTB requires a product evaluation to determine whether a proposed label identifies the product in an adequate and non-misleading way. Pre-COLA product evaluation entails a review of a product's ingredients and formulation and also may include a laboratory analysis of the product. Laboratory analysis involves a chemical analysis of a product.
6. Such pre-COLA product evaluations ensure that:
    - No alcohol beverage contains a prohibited ingredient.
    - Limited ingredients are used within prescribed limitations or restrictions.
    - Appropriate tax and product classifications are made.
    - Alcohol beverages labeled without a sulfite declaration contain less than 10 parts per million (ppm) of sulfur dioxide.
7. The type of pre-COLA product evaluation required for a particular product depends on that product's formulation and origin. TTB regulations require formulas most commonly when flavoring or coloring materials are added. Field investigations can be used to verify the accuracy of these documents. Since TTB does not have access to foreign plants, some imported products are subject to laboratory analysis or pre-import letter approval.
8. The relevant Federal regulations for labeling and advertising of malt beverages can be found Part 7 of Title 27 of the Code of Federal Regulations. Processing times for COLA's can be found : https://www.ttb.gov/labeling/processing-times.shtml.

§7.11 Use of ingredients containing alcohol in malt beverages; processing of malt beverages

(a) *Use of flavors and other nonbeverage ingredients containing alcohol—*

i. (1) *General.* Flavors and other nonbeverage ingredients containing alcohol may be used in producing a malt beverage. Except as provided in paragraph (a)(2) of this section, no more than 49% of the overall alcohol content of the finished product may be derived from the addition of flavors and other nonbeverage ingredients containing alcohol. For example, a finished malt beverage that contains 5.0% alcohol by volume must derive a minimum of 2.55% alcohol by volume from the fermentation of barley malt and other materials and may derive not more than 2.45% alcohol by

volume from the addition of flavors and other nonbeverage ingredients containing alcohol.

ii. (2) In the case of malt beverages with an alcohol content of more than 6% by volume, no more than 1.5% of the volume of the malt beverage may consist of alcohol derived from added flavors and other nonbeverage ingredients containing alcohol.

(b) *Processing.* Malt beverages may be filtered or otherwise processed in order to remove color, taste, aroma, bitterness, or other characteristics derived from fermentation.

iv. Labeling Requirements

Permission to Re-label: Application for permission to re-label shall be accompanied by two complete sets of the old labels and two complete sets of any proposed labels, together with a statement of the reasons for relabeling, the quantity and the location of the malt beverages, and the name and address of the person by whom they will be relabeled.

Land Use, Zoning and Environmental Issues

A. Industrial Waste & Water

a. Breweries use a substantial amount of water and create a large amount of byproduct waste through their operations. (Brewlaw p. 47). The spent grain is considered "industrial waste and must be handled accordingly". *Id.*

b. Be aware that some cities and locations are not friendly to breweries because they use a substantial amount of water. *Id.* Additionally, at drought-stricken areas, your brewery will need to expend more on water as it may be more expensive. *Id.*

B. Pollutants

a. Brewing creates pollutants that must be handled appropriately. These pollutants are governed by different agencies. *Id.*

b. "The wastewater created by boilers, referred to as effluent, is regulated by the Environmental Protection Agency (EPA) for nitrogen oxide level." *Id.*

c. Plan to have a silo? You need to obtain a permit from the Air Pollution Control District (APCD). *Id* at 48.

C. Zoning & Licenses

a. In Minnesota no license to sell intoxicating liquor will be issues within the following areas:

i. Within the Capitol or on the Capitol grounds;

ii. On the State Fairgrounds;

iii. On the campus of the College of Agriculture of the University of Minnesota;

iv. Within 1,000 ft of a state hospital, training school, reformatory, prison, or other institution under the supervision or control of the commissioner of human services or corrections;

v. Within any town or municipality that votes no in favor of liquor licensing

vi. Within 1,500 ft of any public school not within a city; AND

vii. Where restricted against commercial use through zoning. Minn. Stat. 340.412 subd.

Considerations for Clients Doing Business in Multiple States

A. Onus is on the brewery to ensure they are compliant with each state and federal law.

B. Non-extensive checklist for laws:

a. Environmental laws in different states;

b. Zoning;

c. Licensing;

d. Labeling;

D. Federal and State Tax Reporting Requirements
Submitted by Jeff O'Brien

A. Small BREW

SEE ATTACHED FAQ APPENDIX:

- Recalibrated the federal beer excise tax small brewers pay on each barrel of beer produced
- $16 per barrel on first 6 million barrels
- $18 per barrel for remaining barrels
- $3.50 per barrel for first 60,000 barrels for production under 2 million barrels
- Reduced tax rates on distilled spirits

B. TBB Audits- Common Errors and Penalties

i. Critical Recordkeeping, Production and Inventory Mistakes

a. Software options available to assist with record keeping - Only as accurate as the data entered

1. Maintain daily records of activity
2. Keep track of inventory adjustments
3. Account for waste and disposal of product
4. Have controls in place to ensure information entered and pulled for reporting is timely — i.e., daily rather than weekly
5. Records should be retained for a minimum of 3 years

b. <u>Most common daily recordkeeping mistakes</u>

1. Accurately report the amount of beer returned to the brewery
2. Properly maintain records regarding destruction of beer
3. Appropriately record lab sample removals
4. Appropriately report, record, or maintain supporting documents regarding losses or shortages

c. <u>Inventory Remedy</u>

1. Take inventory of product on the first of each month

2. Document the inventory count(s)
3. Required information:
    a. Date taken
    b. Quantity of beer and cereal beverage on hand;
    c. Losses, gains, and shortages; and
    d. Signature — under penalties of perjury — of the brewer or person taking inventory

ii. Frequent Mishaps: Tanks and Measuring Devices

a. Recording beer that is removed for lab samples

b. Every tank, vat, cask, or other container that a brewer uses or intends to use as a receptacle for wort, beer, or concentrate must be "durably marked with a serial number and capacity."

c. All measuring devices must be tested periodically

d. Records of these tests must be made available to TTB officers upon inspections

e. <u>Records required:</u>

1. Date of test
2. Identification of device(s) tested
3. Test results
4. Any corrective actions (adjustment/repair) taken

iii. Conversion Factors in Calculating Barrel Equivalent Amounts

a. 1 Barrel (bbl) = 31 gallons

b. 1 US Keg = 15 gallons

c. 1 US sixtel (pony keg) = 5.166667 gallons

d. 1 US case of beer = 2.25 gallons

iv. Excise Tax Returns, Computation of Tax and Determination Mistakes

a. Tax is calculated on the beer which is reported to be removed for consumption or sale in the United States

b. Reported tax amounts should match Brewer's Report of Operations

c. Any adjustments should be documented/explained in the appropriate section on form

v. Brewer's Report of Operations (BROP)- Top Blunders and Tips

a. Required form to report operations such as:

1. Inventory levels
2. Production and waste amounts
3. Packaging amounts
4. Removals of product

b. Timely records are required to ensure reported data is accurate

E. Negotiating/ Drafting Brewery and Distillery Contracts

Submitted by Jeff O’Brien

A. Distribution Agreements

State Distribution Laws

i. Distribution laws vary between states. See Appendix 1 for a summary of each state's law.

Franchise Laws

A majority of the states have enacted full-fledged beer franchise laws. Although it is not hard to detect a whiff of protectionism in these enactments, their stated purpose is to correct the perceived imbalance in bargaining power between brewers (who are presumed to be big and rich) and wholesalers (who are presumed to be small and local). Temperance concerns are also cited. A full-fledged beer franchise law will usually:

- Define franchise agreements to include informal, oral arrangements, making any shipment to a wholesaler the start of a franchise relationship.
- Prohibit coercive brewer practices, most often including actions in which a brewer (a) requires the wholesaler to engage in illegal acts, (b) forces acceptance of unordered beer, or (c) withholds shipments in order to impose terms on the wholesaler.
- Require "good cause" or "just cause" before a brewer can terminate a wholesaler.
    - The burden is generally on the brewer to demonstrate cause for termination.
    - "Good cause" is usually defined to include a significant breach of a "reasonable" and "material" term in the parties' agreement.

- Dictate that a brewer give prior written notice (60 or 90 days is common) to a wholesaler before termination is effective, with the notice detailing the alleged deficiencies that justify termination.
- Grant wholesalers an opportunity to cure the deficiencies alleged in a termination notice, with termination ineffective if a wholesaler cures the defect(s) or presents a plan to cure the defect(s).
    - "Notice-and-cure" requirements usually are waived under certain circumstances. These most often include a wholesaler's (a) insolvency, (b) conviction or guilty plea to a serious crime, or (c) loss of a license to do business. Many franchise laws also permit expedited termination where a wholesaler (d) has acted fraudulently or (e) has defaulted on a payment under the agreement despite a written demand for payment.
- Require wholesalers to provide brewers with notice of any proposed change in ownership of the wholesaler, giving the brewer an opportunity to object. The brewer's approval of an ownership change cannot be "unreasonably" withheld.
    - Brewers usually have little or no right to block a transfer to a previously designated family successor.
- Create remedies for unfair termination, generally granting wholesalers the right to receive "reasonable compensation" following termination.
    - Most beer franchise laws grant wholesalers the right to seek an injunction that, if granted, would quickly halt termination proceedings pending the resolution of wrongful termination claims. The forum for such relief can be either a state court or the state's alcohol control authorities.

    - Although arbitration of the entire dispute is not required, and sometimes prohibited, disputes over what constitutes "reasonable compensation" often must be arbitrated at the request of a party.
    - Even if the franchise law prohibits arbitration, an arbitration clause in the parties' written agreement is likely enforceable under the Federal Arbitration Act if the parties reside in different jurisdictions.
- Declare any waiver of franchise law protections void and unenforceable.
- Set a date that the law becomes effective. Some franchise agreements may predate franchise acts' effective dates, likely making the franchise law inapplicable to that agreement.

In addition to the extremely common provisions described above, other terms may:

- Require beer franchise agreements to be in writing.
- Mandate that sales territories be exclusive.
    - Wholesalers may face substantial penalties for making deliveries outside their designated territory, and such conduct may permit expedited termination by the brewer.
    - Territorial designations may need to be filed with state liquor control authorities.
- Restrict a brewer's ability to dictate prices, with restrictions that often go beyond the strictures of antitrust law. Common provisions prohibit brewer price fixing, require brewers to file and adhere to periodic price schedules, and ban price discrimination between wholesalers within the state.

- Provide that the prevailing party in a termination dispute will be compensated for its attorneys fees.
- Bind succeeding brand owners to existing franchise agreements, although some permit not-for-cause termination after a change in brand ownership, as long as compensation is paid.
- Impose a good faith obligation on both parties. Under modern contract law, this good faith obligation is already implied in all contractual relations.
- Impose specific obligations on wholesalers, occasionally specified to include a duty to properly rotate stock, maintain tap lines, and comply with other reasonable quality control instructions.

Most states have enacted at least a few laws that regulate brewer-wholesaler relations. In some, beer wholesalers are covered by a franchise law protecting all alcohol beverage wholesalers. In a few states, beer wholesalers are protected by franchise laws that apply to a variety of franchise relationships, from beer to burgers. Still others partially regulate beer franchise relationships through their alcohol control laws by, for example, requiring exclusive territories as a condition for licensing. Finally, a few states and the District of Columbia have, to date, left brewer-wholesaler relations essentially unregulated, thereby allowing the franchise relationship to be governed exclusively by the terms of the parties' agreement, to be enforced under general contract law principles.

Appendix 1 sets forth a state-by-state summary of beer distribution laws.

Self-Distribution

Many states permit breweries below a certain production threshold to distribute their product directly to retailers without the use of a distributor. While self-distribution can be a viable means around the complex and onerous franchise laws, the time and capital required to operate an effective distribution system is significant and tends to detract from other operations. Further, breweries that grow beyond the production thresholds are forced into the franchise system as they lose their rights of self-distribution.

Appendix 2 sets forth a state-by-state summary of these self-distribution laws.

Small Brewer Exemptions

In response to the continued consolidation of beer wholesalers in the U.S. and the imbalance in negotiations between larger wholesalers and small craft brewers, several states have created exemptions within their distribution laws for "small brewers" relative to the onerous termination provisions:

- Arkansas: Small brewers within the state are fully exempt from any remedies under the state's franchise act. Ark. Code Ann. §§ 3-5-1102(12)(B); 3-5-1403(13). An Arkansas statute defines a small brewery as a "licensed facility that manufactures fewer than thirty thousand (30,000) barrels of beer and malt beverages per year for sale or consumption." Ark. Code Ann. § 3-5-1403(13).
- Colorado: None of the state's franchise protections are enforceable against small manufacturers. Colo. Rev. Stat. § 12-47-406.3(8). Specifically, the applicable statute exempts manufacturers that produce "less than three hundred thousand [300,000] gallons of malt beverages per calendar year." *Id.*

- Illinois: The state's franchise provisions allow small brewers whose annual volume of beer products supplied represents 10 percent or less of the wholesaler's entire business to terminate upon payment of reasonable compensation to the wholesaler. 815 Ill. Comp. Stat. 720/7.
- Nevada: The state's good cause franchise protection against terminations is not enforceable against small suppliers in-state and out-of-state. Nev. Rev. Stat. § 597.160(2). Specifically, the statute exempts suppliers that sell "less than 2,000 barrels of malt beverages . . . in this state in any calendar year." *Id.*
- New Jersey: A brewer from within or without the state who succeeds another brewer is exempt from a rebuttable presumption that favors an injunction preventing termination of the preexisting wholesaler when the affected brands represent a small portion (*i.e.*, less than 20 percent) of the terminated wholesaler's gross sales, the terminated wholesaler receives compensation, and the brewer assigns the brands to a wholesaler that already distributes its other brands. N.J. Rev. Stat. § 33:1-93.15(4)(d)(1).
- New York: A small brewer whose annual volume is less than 300,000 barrels produced in the state or outside of the state and who represents only a small amount (*i.e.*, no more than three percent) of a wholesaler's total annual sales volume, measured in case equivalent sales of twenty-four-twelve ounce units, may terminate a wholesaler upon payment of compensation for only the distribution rights lost or diminished by the termination. N.Y. Alco. Bev. Cont. Law § 55-c(4)(c)(i). The statute defines "annual volume" as "the aggregate number of barrels of beer" brewed by or on behalf of the brewer under trademarks owned by the brewery, or the aggregate number of barrels of beer brewed by or on behalf of any person controlled by or under common control with

the brewer, "during the measuring period, on a worldwide basis." N.Y. Alco. Bev. Cont. Law § 55-c(4)(c)(iv).

- North Carolina: A small brewer may terminate a wholesaler upon payment of compensation for the distribution rights with five days' written notice without establishing good cause. N.C. Gen. Stat. § 18B-1305(a1). North Carolina's alcohol beverage statutes define a small brewer as "a brewery that sells, to consumers at the brewery, to wholesalers, to retailers, and to exporters, fewer than 25,000 barrels . . . of malt beverages produced by it per year." N.C. Gen. Stat. § 18B-1104(8).
- Pennsylvania: Although not a small brewer carve-out, the state's franchise provisions exempt in-state manufacturers whose principal place of business is in the state, "unless they name or constitute [or have named or constituted] a distributor or importing distributor as a primary or original supplier of their products." 47 Pa. Cons. Stat. § 431(d)(5). **Warning**: this provision likely violates the Commerce Clause of the U.S. Constitution.
- Rhode Island: Although not a small brewer carve-out, the state's franchise laws exempt Rhode Island-licensed manufacturers. R.I. Gen. Laws § 3-13-1(5). **Warning**: this provision likely violates the Commerce Clause of the U.S. Constitution.
- Washington: Small brewers holding certificates of approval are excluded from the state's franchise protections. Wash. Rev. Code § 19.126.020(10). Specifically Washington's franchise law excludes from the definition of "supplier" "any brewer or manufacturer of malt liquor producing less than two hundred thousand [200,000] barrels of malt liquor annually." *Id.*

Distillery Distribution Issues

ii. Regarding distilleries, most states do not have statutory distribution provisions similar to breweries. In Minnesota, for example, a distillery can have a distribution agreement for a term certain and is not subject to the franchise-type termination provisions described hereinabove. However, distilleries typically have little to no rights of self-distribution

B. <u>Contract Production Agreements</u>

- Definition: a brewery that hires another brewery to produce its beer. The licensor generally handles marketing and brand development of the beer, while leaving the brewing and packaging to the licensee brewery.

- Pros of Contract Brewing:
  - Can help alleviate producer brewery supply issues to meet demands.
  - Producer breweries avoid costs since they do not need to own a brewing facility

Most states provide that employees are "at will" employees; that is, they can leave their employment whenever they wish, for any reason or no reason. If a business owner has a key employee that is integral to its success, that employee should have a written employment agreement that provides for a fixed term of employment. A covenant not to compete can be included to deter a key employee from leaving to work for a competitor. Absent this type of agreement, the key employee can leave at any time.

A written employment agreement is imperative for your head brewer who knows a brewery's formulas could do the most damage to the business working for the competition. Hence, a master brewer employment agreement should include a covenant not to compete and provisions that clearly state that the beer formulas are "trade secrets" and thus the property of the brewery.

Covenants not to compete must be narrowly tailored to balance the interests of employer and employee. The employer must show (i) the covenant not to compete was supported by consideration when it was signed (if the consideration for the covenant is the continued

employment of the employee, then the covenant must be signed prior to the start of employment to be valid); (ii) the covenant protects a legitimate business interest of the employer; and (iii) the covenant is reasonable in duration and geographic scope to protect the employer without being unduly burdensome on the former employee's right to earn a living.

Use of "Volunteers"

Many breweries take advantage of the abundance of people interested in helping their business grow by allowing them to volunteer at the brewery. Depending upon the nature of the duties they are performing, classifying an individual who ought to be treated – and compensated – as an employee as a "volunteer" can lead to significant penalties under Minnesota and federal law. In the past few years as both state and federal government have tried to get more revenue, they have focused on going after employers for misclassification of workers, whether they be independent contractors, interns or the use of volunteers.

Minnesota Law:

There is a presumption anyone performing work for a "for-profit" enterprise is an employee. In Minnesota, the nature of the employment relationship is determined by using worker classification tests, similar to the manner in which employee status is determined under both workers' compensation and unemployment insurance laws. Compensation of Minnesota employees is determined under Minn. Stat. § 181.722, Subd. 3, and the federal Fair Labor Standard Act. Correctly assessing a worker as an employee, student/intern, independent contractor, or volunteer is critical.

Minnesota Statute Section 177.23 governs the use of volunteers. Minn. Stat. §177.23, Subd. 5 states that "Employ" means “to permit to work”, and Subd. 6 states that an “Employee” means any individual employed by an employer, subject to certain enumerated exceptions. There is an exception for “any individual who renders service gratuitously for a nonprofit organization”, but there is no exception for an individual who renders service gratuitously for a for-profit organization.

Federal Law:

The Fair Labor Standards Act (FLSA) defines employment very broadly, i.e., "to suffer or permit to work." However, the Supreme Court has made it clear that the FLSA was not intended "to stamp all persons as employees who without any express or implied compensation agreement might work for their own advantage on the premises of another." In administering the FLSA, the Department of Labor follows this judicial guidance in the case of individuals serving as unpaid volunteers in various community services. Individuals who volunteer or donate their services, usually on a part-time basis, for public service, religious or humanitarian objectives, not as employees and without contemplation of pay, are not considered employees of the religious, charitable or similar non-profit organizations that receive their service. Members of civic organizations may help out in a sheltered workshop; men's or women's organizations may send members or students into hospitals or nursing homes to provide certain personal services for the sick or elderly; parents may assist in a school library or cafeteria as a public duty to maintain effective services for their children or they may volunteer to drive a school bus to carry a football team or school band on a trip. Similarly, an individual may volunteer to perform such tasks as driving vehicles or folding bandages for the Red Cross, working with disabled children or disadvantaged youth, helping in youth programs as camp counselors, scoutmasters, den mothers,

providing child care assistance for needy working mothers, soliciting contributions or participating in benefit programs for such organizations and volunteering other services needed to carry out their charitable, educational, or religious programs.

Under the FLSA, employees may not volunteer services to for-profit private sector employers. On the other hand, in the vast majority of circumstances, individuals can volunteer services to public sector employers. When Congress amended the FLSA in 1985, it made clear that people are allowed to volunteer their services to public agencies and their community with but one exception - public sector employers may not allow their employees to volunteer, without compensation, additional time to do the same work for which they are employed. There is no prohibition on anyone employed in the private sector from volunteering in any capacity or line of work in the public sector.

Student/Interns:

Until recently, student/interns have not received the same close scrutiny as other groups of workers. Student/interns are <u>not</u> considered employees under both state and federal law, if their use in the workplace generally passes six tests offered by the Department of Labor. The tests are:

1. The training experience is similar to what is provided at school;
2. The training experience is for the benefit of the student/interns;
3. The student/interns do not displace regular employees;
4. The employer providing the training receives no immediate advantage from the activities of the trainees;
5. Student/interns are not necessarily entitled to a job at the conclusion of the training; and

6. The employer and the student/interns understand the work is unpaid training.

Whether an employment relationship exists is not always clear. Instead, whether an intern or trainee is entitled to such things minimum wage and overtime compensation will often depend upon whether the individual is receiving training without displacing other employees or providing any real benefit to the employer. (Note: a reasonable stipend may be permitted)

Independent Contractor:

Independent contractors are hired to perform special services of a limited scope and duration, and they typically perform the same services for a variety of businesses. The standards in Minnesota to be considered in determining whether or not an individual is an employee or an independent contractor depend upon the purpose for which such classification is to be considered but typically include factors such as:

1. The right to control the means and the manner of performance;
2. The mode of payment;
3. The furnishing of materials or tools;
4. The control of the premises where the work is done; and
5. The right of the employer to discharge the individual.

Generally, the more control, or right of control, an employer has over the individual performing the work, the work site, and the nature, quality, and manner in which work is performed, the more likely the relationship is an employer-employee relationship vs. an independent contractor arrangement.

B. <u>Agreements with Suppliers</u>

C. Licensing Agreements

D. Alternating Proprietorships

Definition: An arrangement in which two or more people take turns using the physical premises of a brewery. Generally, the proprietor of an existing brewery, the "host brewery", agrees to rent space and equipment to a new "tenant brewer."

Pros of an Alternating Proprietorship:

i. Tenant brewers can develop a brand before they are ready to invest in their own premises and equipment.

ii. Tenant brewer may be eligible for a lower tax rate on beer.

iii. Host breweries can offset their investment by renting out their excess capacity.

	Alt Prop	Contract Brewing
Title Ownership	Tenant brewer holds title to its beer, including the ingredients and raw materials it uses to produce its beer, during all stages of production.	Contract brewer holds title to the beer, including the ingredients and raw materials used to brew the beer, during all stages of production.
Record Keeping	Tenant brewer and host brewer each retain their own records for production and removal of beer and each provides reports to the TTB.	Contract brewer retains all records of production and removal of beer and provides reports to the TTB.
Taxes	Tenant brewer and host brewer are individually responsible for paying their own taxes on their own beer removed from the brewery.	Contract brewer is solely responsible for paying taxes on beer removed from the brewery.
Brewer Licensure	Tenant brewer and host brewer must each qualify as a brewer and have separate licenses.	Only the contract brewer must qualify as a brewer, so the producer brewer does not need a license.
Ease of Paperwork	Requires significant paperwork for both parties.	Simple agreement; Brand is added to the contract brewer's Notice.

E. Equipment, Retail, Production and Distribution Space Leases

i. **Distribution Space Leases**

i. As the old cliché goes, in real estate it's all about "location, location, location", and this is especially true for a brewery or distillery business. If you're looking to be the neighborhood hangout complete with a taproom (for breweries) or cocktail room (for distilleries), you'll need to find a suitable space close to

home. Should you have larger ambitions, you may seek a more strategic location amenable to later expansion. Whatever the case may be, you'll need to have a space secured in order to complete the licensing process.

ii. A new brewery or distillery owner will most likely lease a building at the start, and negotiating a suitable lease is a crucial step in the process.

iii. Commercial lease agreements typically come in one of two varieties: "triple net" and "gross."

iv. In a triple net, the tenant pays rent to the landlord, as well as a pro rated share of taxes, insurance and maintenance expenses. In the typical triple net lease, the tenant pays a fixed amount of base rent each month as well as an "additional rent" payment which constitutes 1/12 of an estimated amount for taxes, insurance and maintenance expenses (also called CAM or common area maintenance expenses). At the end of the lease year, the estimated amounts are compared to actual expenses incurred and adjusted depending upon whether the tenant paid too much or too little through its monthly payments.

v. In a "gross" lease, the landlord agrees to pay all expenses which are normally associated with ownership. The tenant pays a fixed amount each month, and nothing more.

F. <u>Additional Contracts and Agreements</u>

Breweries and distilleries, like most businesses, face a myriad of insurance requirements. In addition to the surety bond required to obtain their license, breweries and distillers will need several types of coverages including:

- General liability insurance;

- Workers compensation; and
- Dram shop (if the business is serving alcohol for on-premise consumption).

With respect to general liability coverage, given the growth in breweries and distilleries and the increase in trademark and other intellectual property related disputes, it is imperative to carry coverage for these issues.

Many insurance companies now have special “craft brewery programs” which provide breweries with a package tailored to the needs of the industry.

F. Intellectual Property, Marketing and Advertising

Submitted by Jeff O'Brien

A. Disputes Regarding Beer Names and Trademarks

1. Purposes of trademarks

    a. Indicate product source

    b. Distinguish products from each other and competitors

    c. Protect company's investment in its business and brand

    d. Protect consumer expectations of quality

2. U.S. Breweries continue to increase with a 16 percent growth from 2016 to 2017

    a. Saturation in the market leads to increased trademark infringement litigation and inter partes proceedings before the Trademark Trial and Appeal Board.

B. Issues with Protecting Trademarks and Characteristic Beer Bottle Trade Dress

1. Nearly any matter that distinguishes the source of one product from another can qualify as a trademark, including, words, designs, color, product configurations, packaging and containers, sales environments, scents, sounds and touch.

2. Trade dress generally refers to the overall appearance or image of a product, including features such as size, shape, color, texture, or graphics. *John H. Harland Co. v. Clarke Checks, Inc.*, 711 F.2d 966, 980 (11th Cir. 1983). When considered in the context of breweries, trade dress generally applies to beer bottles, tap handles or a taproom's layout or design.

3. Issues in obtaining trade dress protection include issues with functionality and distinctiveness.

    a. Functionality: A product or its attribute may not be protected as trade dress if it serves a functional purpose. The purpose underlying the non-functionality rule is to prevent producers from acquiring monopolies so as to ensure that functional characteristics are available to all competitors in the marketplace.

i. Functional means any attribute that makes the product more useful, or more easily used, or that contributes to the ease or economy of manufacture or distribution.

ii. Courts apply two tests in determining functionality: utilitarian functionality and aesthetic functionality. Under the traditional utilitarian functionality test, a product feature will be considered functional if it is essential to the use or purpose of the article or if it affects the cost or quality of the article. *Inwood Labs., Inc. v. Ives Labs., Inc.*, 456 U.S. 844, 850 n.10 (1982). Under the aesthetic functionality test, a product feature will be considered functional if it is one, the exclusive use of which, would put competitors at a non-reputation related disadvantage. *Qualitex Co. v. Jacobson Products Co., Inc.*, 514 U.S. 159, 165 (1995).

b. Distinctiveness: A product or its attribute's ability to identify a single source of goods or services, even if the source is unknown. Distinctiveness may be either inherent or acquired (known as secondary meaning).

i. Inherently distinctive trade dress is immediately capable of identifying a source of origin for a good or service. *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 768 (1992). Courts vary in the test applied in determining whether trade dress is inherently distinctive with some applying the same spectrum used for assessing traditional word marks (generic, descriptive, suggestive, arbitrary, fanciful), *Abercrombie & Fitch Co. v. Hunting World, Inc.*, 537 F.2d 4, 9 (2d Cir. 1976), and others applying a four-factor test of whether the trade dress is common or basic, unique or unusual in a particular field, a mere refinement of a commonly adopted and well-known form of ornamentation for a particular class of goods or services viewed by the public as dress or ornamentation, and capable of creating a commercial impression distinct from any accompanying words, *Seabrook Foods, Inc. v. Bar-well Foods Ltd.*, 568 F.2d 1342 (C.C.P.A. 1977).

ii. Acquired distinctiveness is trade dress that has obtained distinctiveness through use or promotion over time. In determining whether dress has acquired distinctiveness, courts consider a variety of evidence, including, consumer testimony, surveys, exclusivity, manner and length of use, amount and manner of advertising, amount of sales, number of customers, establishment in the marketplace, and proof of intentional copying by an infringer.

C. Trademark Difficulties With PTO Considering Beer in Same Class as Wine and Spirits

1. In order to establish a likelihood of confusion, the goods or services at issue do not need to be identical or directly competitive, but instead merely "related in some manner and/or if the circumstances surrounding their marketing [be] such that they could give rise to the mistaken belief that [the goods or services] emanate from the same source." *Coach Servs., Inc. v. Triumph Learning LLC*, 101 U.S.P.Q.2d 1713, 1722 (Fed. Cr. 2012).
    a. The nature and scope of a party's goods or services is determined based on the goods or services recited in the application or registration. The International Class identification "is wholly irrelevant" to a likelihood of confusion claim. *Jean Patou, Inc. v. Theon, Inc.*, 29 U.S.P.Q.2d 1771, 1774 (Fed. Cir. 1993).

2. The Trademark Trial and Appeal Board and courts have recognized that beer and wine and other alcoholic beverages are related. The Trademark Trial and Appeal Board and the courts' finding of relatedness is often supported by evidence demonstrating that the same entity offers both products at issue thereby establishing that consumers are accustomed to seeing the goods emanating from the same source.

3. Clearance searches need to be conducted in order to determine whether a trademark is available. There are generally two types of clearance searches that can be performed: (1) a preliminary search and (2) a comprehensive search. Because the Trademark Trial and Appeal Board and the courts are finding that beer is related to other alcoholic beverages, including wine, a proper trademark clearance search for a mark that is going to be used in connection with beer needs to include a search of marks used in connection with other alcoholic beverages, including wine.

    a. A preliminary search is a quick knock out search of the USPTO's database to identify clear problems.

    b. A comprehensive search looks at not only the USPTO's database, but also common law uses, such as websites and state databases.

4. Adopt strong marks at the outset. Stronger marks provide a wider range of exclusivity and are immediately protectable.

D. Intellectual Property Infringement: Difficulties in Protecting Breweries and Distilleries in a Competitive Market.

1. To maintain trademark rights, trademark owners need to be diligent in protecting their marks against infringement and misuse by third parties as failure to do so may diminish the value of the marks.

a. Proper protection of a trademark owner's rights includes monitoring the marketplace for infringement or misuse of the mark and monitoring third-party applications. Trademark owners should develop, and follow, a trademark enforcement strategy prior to any potential infringement or misuse.

2. Formal action to enforce trademark rights include actions before the Trademark Trial and Appeal Board to oppose third party registrations and to cancel existing registrations. The Trademark Trial and Appeal Board can only address registration of the trademark; it cannot issue injunctions or monetary awards.

3. Formal action to enforce trademark rights also includes commencing litigation before the court. Claims may include trademark infringement and unfair competition. The court may award injunctive relief and monetary damages.

4. Before pursing formal action, the trademark owner may consider whether the infringement or misuse may be resolved informally. This could include contact between the business owners or a cease and desist letter issued by an attorney.

E. Challenges in Protecting and Copyrighting Brewing Recipes and Processes

1. Copyright protects original works of authorship. The works of authorship include literary works, musical works, dramatic works, pantomimes and choreographic works, pictorial, graphic and sculptural works, motion pictures and other audiovisual works, sound records and architectural works. 17 U.S.C. § 102(a).

a. Copyright does not protect ideas, procedures, methods, systems, processes, concepts, principles or discoveries.

2. A recipe is a statement of the ingredients and procedure required for making a dish
of food or beverage. Copyright does not protect recipes that are mere listings of ingredients. However, a recipe that creatively explains or depicts how or why to perform a particular activity may be copyrightable. If registration is afforded in this instance, the registration will not extend to the list of ingredients that appear in the recipe or the underlying process for making the recipe.

F. Brewery and Distillery Confidentiality/Non-Disclosure Agreements: Hidden Dangers that Make Them Unenforceable.

1. Breweries and distilleries that share, receive and exchange confidential information with and from customers, suppliers and other parties would benefit from and should implement the use of confidentiality and nondisclosure agreements to protect their confidential information and data. Effective protection of confidential information and data, however, includes not only

having confidentiality and nondisclosure agreements in place, but also having comprehensive policies and procedures regarding confidential information and data.

2. Confidentiality/Non-Disclosure agreements generally include the following provisions:

    a. The parties to the agreement (business entities or individuals).

        i. If a Confidentiality/Non-Disclosure agreement is signed by someone who does not have the power to execute a binding agreement, it could potentially invalidate the agreement.

        ii. If the Confidentiality/Non-Disclosure agreement is entered into by a business entity, it is important to ensure that the correct legal name of the business entity is used in order to bind the correct party.

    b. The business purpose of the agreement.

        i. Identifying a business purpose limits the disclosure or exchange of confidential information to the specified business purpose.

    c. The definition of confidential information.

        i. Confidential information should be defined broadly enough to cover all of the confidential information that may be disclosed and to identify the type of information that is confidential. However, confidential information should not be so broadly defined that it is unenforceable.

    d. Identification of what is excluded from the definition of confidential information.

        i. Generally information that is or becomes public other than through breach of the agreement, was already in the recipient's possession or was available to the recipient on a non-confidential basis prior to disclosure, is received from a third party not bound by the confidentiality agreement, or is independently developed by the recipient without use of the confidential information is excluded from the definition of confidential information.

    e. Use and access restrictions.

i. Access to the confidential information may be restricted even within a business entity, such as, to those employees who have a "need to know."

f. Safekeeping and security requirements.

i. The Confidentiality/Non-Disclosure agreement may identify the manner in which the confidential information is stored, including, network security protections.

g. The term of the agreement and any survival provisions.

i. A Confidentiality/Non-Disclosure agreement may be perpetual or terminate on a specified date or event. If the agreement terminates on specified date or event, a set period can be defined during which the nondisclosure obligations remain in effect after expiration of the agreement.

h. Provisions relating to return or destruction of confidential information.

i. Intellectual property rights.

i. Confidentiality/Non-Disclosure agreements generally provide that the disclosing party retains the intellectual property rights in the confidential information being disclosed and disclaims any license to the recipient.

G. Advertising Breweries and Distilleries: Mandatory Statement Challenges.

1. The Alcohol and Tobacco Tax and Trade Bureau ("TTB") defines "advertisement" as any written or verbal statement, illustration, or depiction, which is in, or calculated to induce sales in, interstate or foreign commerce, or is disseminated by mail. 27 C.F.R. § 7.51.

a. The definition includes any written, printed, graphic, or other matter accompanying the container; markings on cases, billboards signs, or other outdoor display; and broadcasts made via radio, television, or in any other media. *Id.* Examples include ads in newspapers or magazines, trade booklets, menus, wine cards, leaflets, circulars, mailers, book inserts, catalogs, promotional materials, or sales pamphlets. *Id.*

2. Advertisements for malt beverages need to include the following information:

a. Name and address (city and State) of the permittee responsible for the advertisement; and

b. Class to which the product belongs, corresponding with the information shown on the approved label, *e.g.*, lager, ale, stout. 27 C.F.R. § 7.52.

3. The TTB also identifies what may not be included in advertisements for malt beverages. See 27 C.F.R. § 7.54 for a complete list of prohibited statements. From a trademark perspective, the most applicable prohibitions are:

   a. No names that are misleading with respect to the characteristics of the product;

   b. No statements that are disparaging of a competitor's product; and

   c. No statements, designs, devices or representations that are obscene or indecent.

4. The TTB monitors the advertising of malt beverages through pre-clearance of advertising materials, referrals and/or complaints and internal selections for review.

   a. The TTB offers business owners a voluntary, free of charge advertising pre-clearance service in which the TTB reviews an advertisement for compliance with applicable advertising regulations.

Appendix 1

Summary of State Beer Franchise/Distribution Laws

State	Summary of Law	Statutory Citation
Alabama	• Written agreement required. • Exclusive territories. • State approval required before a brand is transferred. • Termination upon 60 days' notice, with wholesaler allowed to submit a plan for cure within 30 days and to cure defects within 120 days. • Immediate termination where wholesaler becomes insolvent, loses license for more than 61 days, or is convicted of a felony. • Termination on 15 days' notice for fraudulent conduct, sales outside territory, failure to pay after a written demand for payment, or a transfer of the business without brewer's permission. • Termination must be made in good faith and for good cause. • Good cause includes failure to comply with agreement provision that are reasonable and of material significance.	Ala. Code §§ 28-8-1 to 28-9-11
Alaska	• No beer franchise law	n/a
Arizona	• Exclusive territories are permitted, but not required. • Termination must be made in good faith and for good cause. • Good cause includes a failure to comply with a term in the franchise agreement, unless that term is unconscionable or requires an illegal act.	Ariz. Rev. Stat. §§ 44-1565 to 44-1567
Arkansas	• Exclusive territories, filed with the State. • Termination requires 30 days' notice with opportunity to cure. • No termination without good cause and good faith. • Good cause includes a wholesaler's insolvency, repeated violations of law, or failure to maintain a reasonable sales volume. • Immediate termination permitted for a number of reasons, including insolvency, license loss for more than 31 days, and sales outside of the wholesaler's territory. • Small brewery (less than 30,000 barrels a year) is not a supplier and exempted from the above provisions.	Ark. Code Ann. §§ 3-5-1101 to 3-5-1111 and § 3-5-1416.

California	• Territorial appointments must be in a written agreement, filed with the State. • Regardless of the parties' agreement, supplier may not terminate a wholesaler solely for wholesaler's "failure to meet a sales goal or quota that is not commercially reasonable under prevailing market conditions." • Some brewer-wholesaler relationships, particularly those involving large brewers, might be covered under California's general Franchise Relations Act. • A manufacturer that unreasonably withholds consent to transfer can be liable for damages. • Recent unpublished Attorney General letter suggested that manufacturer approval rights over wholesaler personnel decisions and business plans, impositions of changes to wholesaler standards or agreements, control over other manufacturers' brands, and control of wholesaler ownership changes are unlawful under the California Alcoholic Beverage Control Act. • In Crown Imp., LLC v. Classic Distrib. & Beverage Grp., Inc., to be published Cal. App. 3d (2014), the court found that even if you interpret the letter to disallow for a manufacture to unreasonably withhold consent to a sale of the distributorship, the law specifically allows for this and a specific statue controls.	Cal. Bus. & Prof. Code §§ 25000.2 to 25000.9
Colorado	• Exclusive territories in a written contract, filed with the State. • Franchise protections applicable to manufacturers producing at least 300,000 gallons of malt beverages annually. • Termination upon 60 days' notice, with wholesaler opportunity to cure during that period. • Grounds for immediate termination include failure to pay after written demand, insolvency, license loss for more than 14 days, fraud, and sales outside of the wholesaler's territory. • Not-for-cause termination permitted upon 90 days' written notice, with copies to all other wholesalers in all other states with the same agreement.	Colo. Rev. Stat. §§ 12-47-405 to 12-47-406.3
Connecticut	• Franchise protections apply following product distribution for more than six months. • Termination in writing, setting forth reasons and giving the wholesaler an opportunity to challenge. • Prior to termination, a brewer may appoint a replacement wholesaler, provided that the appointment is not effective until six months after the wholesaler receives notice of termination. • Termination for "just and sufficient cause," to be determined in a hearing before the Liquor Control Commission.	Conn. Gen. Stat. § 30-17

Delaware	• Territorial arrangements filed with the State. • Where parties have an exclusive arrangement, brewer must obtain ABCC consent before appointing a second distributor. • Termination upon 60 days' notice, with wholesaler opportunity to cure during the notice period. • Good cause is required to terminate a wholesaler without paying "reasonable compensation," which includes the laid-in cost of inventory and goodwill. • Good cause includes, among others, a wholesaler's refusal to comply with a material provision of the franchise that is essential, fair, and reasonable; failure to meet reasonable and fair performance standards; insolvency; and license loss for more than 30 consecutive business days. • Not-for-cause termination is allowed, provided the brewer receives the permission of the Commission to pay "reasonable compensation" and the termination does not violate the terms of the franchise agreement.	Del. Code Ann. tit. 6, §§ 2551 to 2556; 4 Del. Code Regs. § 46
District of Columbia	• No beer franchise law	n/a
Florida	• Exclusive sales territories, in writing, and filed with the State. • Termination upon 90 days' notice, with wholesaler permitted to cure defects within the notice period. • Termination without good cause is forbidden. • Good cause includes a violation of a reasonable and material contract term. • Termination upon 15 days' notice is allowed in certain instances such as insolvency, license loss for more than 60 days, fraud, and sales outside of the wholesaler's territory.	Fla. Stat. §§ 563.021 to 563.022
Georgia	• Exclusive sales territories, filed with the State. • Termination notice containing specific reasons for termination must be filed with the State, giving the State and wholesaler 30 days to object and request a hearing. Georgia Department of Revenue decides whether to allow a termination. • Justifications for termination include a wholesaler's financial instability, repeated violations of law, or failure to maintain sales volume that is reasonably consistent with other wholesalers of the brand.	Ga. Code Ann. §§ 3-5-29 to 3-5-34; Ga. Comp. R. & Regs. 560-2-5.10
Hawaii	• No beer franchise law	n/a
Idaho	• Territorial agreements must be filed with the State. • Termination upon 90 days' notice, with 30 days to submit a plan of corrective action and an additional 90 days to cure defects. • Termination without notice-and-cure permitted upon the wholesaler's bankruptcy, conviction of a felony, loss of license for more than 30 days, sales outside of the wholesaler's territory, transfer without consent, failure to pay within five business days of written demand for	Idaho Code Ann. §§ 23-1003; 23-1101 to 23-1113

	payment, or fraud.	
Illinois	• Written contract required. • Exclusive territories permitted. • Termination upon 90 days' notice, with opportunity for the wholesaler to cure within notice period. • Immediate termination permitted for wholesaler's insolvency, default on payments, conviction of a serious crime; attempt to transfer business without approval, permit revocation or suspension, or fraud in dealing with the brewer. • Termination must be for good cause, following good faith efforts to resolve disagreements. • Good cause includes failure to comply with essential and reasonable requirements of the franchise agreement that are consistent with the law. • A brewer may not discriminate among wholesalers when enforcing agreements with wholesalers. • Small suppliers whose annual volume of beer products supplied represents 10% or less of wholesaler's entire business have a mechanism to terminate upon payment of reasonable compensation to the wholesaler. • Compensation, if not agreed upon, subject to a potentially lengthy arbitration or litigation process. Pending bill (as of April 2014) seeks to amend to permit termination in 6 months while process proceeds.	815 Ill. Comp. Stat. 720/1 to 720/10
Indiana	• Exclusive territories permitted, not required. • Prohibits unfair terminations by suppliers or wholesalers, described as those without due regard for "the equities of the other party." • Currently pending legislation (as of April 2014) would allow a "small brewer" of less than 30,000 barrels to terminate the agreement without cause with notice and payment of a multiple of gross profit. Number is based on the timing of the termination.	Ind. Code §§ 7.1-5-5-9
Iowa	• Written agreement with exclusive territories required. • Termination upon 90 days' notice, with the wholesaler given 30 days to submit a plan to correct deficiencies within 90 days. • Immediate termination permitted upon a wholesaler's failure to pay when due after written demand, insolvency, dissolution, conviction of a crime that would adversely affect its ability to sell beer, an attempted transfer without approval, fraudulent conduct in dealing with the brewer, license loss for more than 31 days, or sales outside the territory. • Termination must be in good faith and supported by good cause. • Good cause exists if the wholesaler failed to comply with reasonable and materially significant requirements of the agreement that are legal and do not discriminate as compared with the requirements imposed on or enforced against similarly-situated wholesalers. • Good faith means honesty in fact and the observance of reasonable standards of fair dealing in	Iowa Code §§ 123A.1 to 123A.12

	the trade, as interpreted under Iowa's Uniform Commercial Code.	
Kansas	• Agreements must be in writing. • Exclusive territories, filed with the State. • Termination must be for reasonable cause. • Must file written termination notice with the agency at least 30 days before the effective termination date.	Kan. Stat. Ann. § 41-410
Kentucky	• Written contract, designating exclusive territories, filed with the State. • Good cause and good faith required for termination • Termination upon written notice and reasonable opportunity (60 to 120 days) to cure. • Grounds for termination include insolvency, felony conviction, fraud, license loss for more than 31 days, sales outside of the wholesaler's territory, and ownership change without consent.	Ky. Rev. Stat. Ann. §§ 244.585; 244.602 to 244.606
Louisiana	• Written agreement required. • Exclusive territories. • Termination upon 30 days' notice, with termination ineffective if the wholesaler produces a plan for corrective action within the notice period that will cure the defect within 90 days. • Immediate termination permitted for numerous contingencies, including a wholesaler's insolvency, loss of license, conviction of a serious crime, or fraudulent conduct towards the brewer. • Termination for good cause only. • Good cause includes wholesaler's failure to comply with a reasonable and material term of the agreement.	La. Rev. Stat. Ann. §§ 26:801 to 812
Maine	• Exclusive territories, filed with the State. • Termination requires at least 90 days' notice, plus a reasonable time to cure. • Immediate termination permitted upon wholesaler's bankruptcy, loss of license, or conviction of a serious crime. • Termination must be for good cause. • Good cause does not include a change in wholesaler ownership, but includes a wholesaler's loss of license, insolvency, or failure to substantially comply with reasonable and material terms of the agreement.	Me. Rev. Stat. Ann. tit. 28-A, §§ 1451 to 1465
Maryland	• Exclusive territories. • Termination upon 180 days' notice, with 180 days for the wholesaler to cure any deficiency. • No notice required to terminate for a wholesaler's insolvency. • Termination must be for good cause. • Good cause always includes a wholesaler's loss of license.	Md. Code Ann., art. 2B, §§ 17-101 to 17-107

Massachusetts	• No refusals to sell after six months of regular sales. • Termination upon 120 days' notice to wholesaler and the State. • Termination may be suspended upon wholesaler's request, pending a hearing before the Alcoholic Beverage Control Commission. • Pending bill (as of April 2014) would allow for a quicker hearing by the Commission. • Termination only for good cause. • Good cause limited to wholesaler's disparagement of the brewer's product, unfair preference of a competing brand, failure to exercise best efforts, encouragement of improper practices, or failure to comply with contract terms.	Mass. Gen. Laws. ch. 138, § 25E
Michigan	• Written agreement with exclusive territories. • Termination upon written notice, with the wholesaler having 30 days in which to submit a plan to cure deficiencies within 90 days. • Termination upon 15 days' notice is permitted upon a wholesaler's fraud in dealing with the brewer, sales outside its territory, or sales of goods known to be ineligible for sale. • Immediate termination is permitted upon a wholesaler's insolvency, loss of license for more than 60 days, or conviction of a felony. • Termination by the brewer must be in good faith and for good cause. • Good cause is established by a wholesaler's failure to comply with reasonable and material contract terms.	Mich. Comp. Laws §§ 436.1401; 436.1403
Minnesota	• Exclusive territories. • Termination requires 90 days' notice, during which time the wholesaler may cure deficiencies. • Termination upon 15 days' notice permitted upon the wholesaler's insolvency, loss of license, or violation of a significant law. • Termination must be for good cause. • Good cause does not include a change in brewery ownership, but includes a wholesaler's loss of license, bankruptcy, or failure to substantially comply with reasonable and material terms of the franchise agreement.	Minn. Stat. §§ 325B.01 to 325B.17
Mississippi	• Written contract and exclusive territories required. • Termination upon 30 days' notice, with the wholesaler given 30 days to submit a plan to cure deficiencies within 90 days. • Immediate termination is permitted for a variety of contingencies, including a wholesaler's fraudulent conduct towards the brewer, insolvency, loss of license, or failure to make payments according to established credit terms. • Termination must be in good faith, for good cause. • Good cause exists when the wholesaler fails to comply with reasonable and material provisions of the agreement, the deficiency arose within the past two years, and the wholesaler failed to cure.	Miss. Code Ann. §§ 67-7-1 to 67-7-23

Missouri	• Written agreement required. • Exclusive territories presumed unless otherwise provided for by written agreement. • Community of Interest must exist for there to be a franchisor-franchisee relationship per Missouri Beverage co., Inc. v. Shelton Bros., Inc. 669 F3d 873 (2012). The court found no relationship because wholesaler's sales of importer's products never exceed 1.16% of wholesaler's annual sales, its name was not used in marketing, and it made no sizable investments particular to the importer. • Termination upon 90 days' notice. • Immediate termination upon criminal misconduct, fraud, abandonment, insolvency, or issuing an NSF check. • Termination requires good cause. • Good cause includes failure to comply substantially with essential and reasonable terms of the parties' contract, bad faith, or wholesaler's loss of license for more than 31 days.	Mo. Rev. Stat. §§ 311.181 to 311.182; 407.400 to 407.420
Montana	• Written contract, filed with the State. • Agreement must include a list of mandatory terms, and designate exclusive territories. • Termination upon 60 days' notice, with the wholesaler given a reasonable time to cure deficiencies. • Mandatory term in every contract includes a procedure for the regular review and correction of wholesaler deficiencies. • Termination must be for just cause or in accordance with brewer's contract terms, as applied equally to all wholesalers within the State.	Mont. Code Ann. §§ 16-3-217 to 16-3-226
Nebraska	• Written agreement required. • Exclusive territories, filed with the State. • Termination upon 30 days' notice, with the wholesaler given a reasonable opportunity to cure deficiencies within 90 days. • Termination upon 15 days' notice permitted in certain circumstances, including a wholesaler's fraudulent conduct towards the brewer, sales outside its territory, failure to pay according to the agreement's terms and after written demand, and intentional cessation of brand business for more than 31 days. • Immediate termination permitted upon the wholesaler's insolvency, loss of license, conviction of a felony, or an agreement to terminate. • Termination must be in good faith and for good cause. • Good cause includes a wholesaler's failure to comply with reasonable and material provisions of the contract. • Good faith means factual honesty and the "observance of reasonable commercial standards of fair dealing in the trade," as interpreted by the Uniform Commercial Code. • Wholesaler is obligated to maintain clean taps, adhere to the brewer's freshness program, and comply with other reasonable written quality control standards.	Neb. Rev. Stat. §§ 53-201 to 53-223

Nevada	• Exclusive territories presumed, but non-exclusive franchise permitted if specified in writing. • Termination upon 90 days' notice, with 60 days to cure deficiencies. • Termination upon written notice after wholesaler's loss of license for more than 31 days, insolvency, conviction of a felony, fraud toward the brewer, sale of beer to an unlicensed retailer, failure to pay according to agreement and seven days after demand for payment, attempt to transfer without notifying the brewer, or discontinuance of the brewer's brand. • Termination must be for good cause. • Good cause means either the wholesaler's failure to substantially comply with essential and reasonable requirements of the agreement or the wholesaler's bad faith acts in carrying out the agreement. • Brewers selling less than 2,500 bbls. within the State in a calendar year are exempt from the good cause termination requirement.	Nev. Rev. Stat. §§ 597.120 to 597.180
New Hampshire	• Written agreement. • Exclusive territories. • Termination upon 90 days' notice, with wholesaler given a reasonable time to cure deficiencies. • Immediate termination permitted upon the wholesaler's insolvency, loss of license, conviction of a serious crime, willful breach of a material provision of the franchise agreement; attempt to transfer business without notice to the brewer, fraud, or failure to pay account upon demand. • Termination only for good cause. • Good cause generally includes a wholesaler's loss of license, insolvency, or failure to substantially comply with the brewer's reasonable and material requirements.	N.H. Rev. Stat. Ann. §§ 180:1 to 180:12
New Jersey	• Exclusive territories required unless dualing prior to March 1, 2006. • Written agreements required. • Termination upon written notice and 120 days to cure • Immediate termination upon insolvency, felony conviction, fraud, license loss for more than 31 days, intentional sales outside of the wholesaler's territory, or transfer of business without consent. • Good cause required for termination. • Good cause means a wholesaler's failure to substantially comply with a reasonable term of the non-discriminatory franchise agreement.	N.J. Rev. Stat. §§ 33:1-93.12 to 33:1-93.20
New Mexico	• Exclusive territories permitted, and must be filed with the State. • Termination must be in good faith, for good cause. • Good faith means factual honesty and observance of reasonable commercial standards under the circumstances. • Good cause includes a wholesaler's failure to substantially comply with essential and reasonable contract provisions, or bad faith actions. • Good cause does not include wholesaler consolidation.	N.M. Stat. §§ 60-8A-1; 60-8A-2; 60-8A-7 to 60-8A-11

New York	• Written agreements required. • Termination for cause upon written notice, with wholesaler given 15 days (or more by court order) to submit a plan to cure deficiencies within 75 days. • Time for corrective action may be limited by a wholesaler's prior failure to satisfactorily cure deficiencies, or if the brewer's product makes up less than either 1,000 cases or 1/2 of 1% of wholesaler's total purchases. • Wholesaler can demand that brewer supply it with a written plan for curing deficiencies. • Immediate termination permitted upon a wholesaler's insolvency, conviction of a felony, loss of license for more than 31 days, fraudulent conduct towards the brewer, failure to pay monies due under the agreement, acts constituting grounds for termination under the agreement, or under a written agreement to terminate. • Upon 15 days' notice, a brewer may terminate a multiple brand wholesaler within 120 days of a competing brewer's loan to or acquisition of an interest in that wholesaler. • Termination only for good cause. • Good cause includes the brewer's implementation of a national or regional consolidation policy (upon 90 days' notice) that is reasonable, nondiscriminatory, essential, and disclosed in writing, or the wholesaler's failure to comply with a material term of the franchise agreement. • Termination based upon consolidation requires payment of to wholesaler of "fair market value" of wholesaler's lost business. • Small brewers (annual volume less than 300,000 barrels and sales to wholesaler 3% or less of wholesaler's annual business) may terminate an agreement without good cause upon payment of fair compensation to the wholesaler.	N.Y. Alco. Bev. Cont. Law § 55-c
North Carolina	• Exclusive territories, filed with the State. • Termination upon 90 days' notice, with wholesaler given 45 days to cure. • Immediate termination permitted upon the wholesaler's insolvency, loss of license for more than 30 days, conviction of a serious felony, fraudulent conduct in dealing with the brewer, failure to pay for delivered beer, or transfer of the business without notice to the brewer. • Termination requires good cause. • Good cause means a wholesaler's failure to comply with contract terms that are reasonable, material, and not unconscionable or discriminatory. • Good cause does not include a change in either brewery ownership or the right to distribute the brand, sale or transfer of brand rights to a successor supplier, a wholesaler's failure to meet performance standards if imposed unilaterally by the supplier, a wholesaler's establishment of a franchise agreement with another supplier, or a supplier's desire to consolidate franchises. • Small brewery (fewer than 25,000 barrels) exception allows for termination absent good cause following the fifth business day after confirmed receipt of written notice and payment of fair market value.	N.C. Gen. Stat. §§ 18B-1300 to 18B-1308

North Dakota	• Written contract with exclusive territories required. • Termination upon 90 days' notice, with the wholesaler having 90 days to rectify deficiencies. • Immediate termination permitted upon the wholesaler's insolvency, loss of license, or significant violation of the law. • Termination must be for good cause. • Good cause does not include a change in brand ownership, but does include the wholesaler's loss of license, insolvency, or failure to comply with reasonable and material obligations of the agreement.	N.D. Cent. Code §§ 5-04-1 to 5-04-18
Ohio	• Agreement must be in writing. • Exclusive territories. • Termination upon 60 days' notice. • Termination without notice permitted upon wholesaler's insolvency or loss of license for more than 30 days. • Termination must be in good faith and for just cause. • Good faith requires fair and equitable business dealings. • Just cause cannot include the failure to perform an illegal act, the restructuring of a brewer's business, or the transfer of a brand. • A wholesaler must act in good faith, properly represent the brewer, adequately serve the public, and protect the brewer's reputation and trade name.	Ohio Rev. Code Ann. §§ 1333.82 to 1333.87
Oklahoma	• Franchise law applies to "low point beer" (not more than 3.2% ABW). • Franchise protections do not apply to suppliers producing fewer than 300,000 gallons of low point beer per calendar year. • Written agreement, designating exclusive territories. • Good cause required for termination. • Must provide written notice of termination and 60 days to cure defects. • Immediate termination upon written notice permitted if wholesaler engages in unapproved sales outside its designated territory, fails to pay upon written demand, insolvency, loss of license for more than 14 days, felony conviction, violation of a serious law, business transfer without approval, fraud, or ceases to do business for five business days.	Okla. Stat. tit. 37, §§ 163.2; 163.18A to 163.18H (for "low point beer")
Oregon	• Agreement must be in writing and filed with the State. • Exclusive territories required. • Termination upon 90 days' notice, with the wholesaler given 30 days to submit a plan that will correct any deficiency within 60 days. • Immediate termination upon written notice permitted upon the wholesaler's insolvency, loss of license for more than 31 days, conviction of a felony, fraudulent conduct towards the brewer, substantial misrepresentations to the brewer, or for certain unapproved assignments of rights under the agreement. • Termination requires good cause, with the brewer acting in good faith. • Good cause exists where the wholesaler fails to comply with a reasonable and material term of the agreement.	Or. Rev. Stat. §§ 474.005 to 474.115

Pennsylvania	• Pennsylvania brewers are exempt from the franchise law's provisions if they do not designate a distributor as a primary or original supplier and had not done so before 1980. • Written agreement, filed with the State. • Exclusive territories. • Termination upon 90 days' notice, with 90 days to cure any deficiencies. If a deficiency relates to inadequate equipment or warehousing, a wholesaler's positive action to comply with the required change satisfies the cure provision. • Immediate termination permitted upon a wholesaler's insolvency, fraudulent conduct towards the brewer, or loss of license for more than 30 days. • Termination must be for good cause.	47 Pa. Cons. Stat. §§ 4-431; 4-492; 40 Pa. Code § 9.96
Rhode Island	• Licensed Rhode Island brewers are not considered suppliers within the meaning of the franchise law, and are exempt from its requirements. • Written contract required. • Exclusive territories. • Termination upon 90 days' notice, with opportunity to cure within the time frame of the notice. • Immediate termination permitted in case of a wholesaler's insolvency, loss of license, or violation of a law significant to the business. • Termination must be for good cause. • Good cause means the failure to substantially comply with a reasonable requirement of the agreement.	R.I. Gen. Laws §§ 3-13-1 to 3-13-12
South Carolina	• Exclusive territories, in writing, filed with the State. • Termination upon 60 days' notice. • Termination by either party must be fair, and for just cause or provocation.	S.C. Code Ann. §§ 61-4-1100 to 61-4-1320
South Dakota	• Exclusive territories, in writing. • Termination upon written notice that gives wholesaler at least 30 days in which to submit a plan to correct deficiencies within 90 days. • Termination by written notice is permitted upon numerous contingencies, including a wholesaler's loss of license for more than 31 days, insolvency, conviction of a felony, or fraudulent conduct towards the brewer. • Termination must be for good cause, and in good faith. • Good faith imposes a duty on each party to act in a fair and equitable manner. • Good cause means a failure to substantially comply with terms that are reasonable, material, and are not unconscionable or discriminatory.	S.D. Codified Laws §§ 35-8A-1 to 35-8A-20

Tennessee	• Exclusive territories for each brand. • Termination upon 90 days' notice, with the wholesaler having 30 days to submit a plan to correct deficiencies within 90 days. • Termination upon 30 days' notice permitted upon a brewer's discontinuance of the brand in the State (which cannot be reintroduced for one year) or wholesaler's conviction for a significant felony. • Termination upon written notice is permitted upon a wholesaler's loss of license for more than 60 days, insolvency, fraud in dealing with the brewer, sales outside its designated territory, or failure to pay monies due under the agreement within five days of demand. • Termination must be in good faith, for good cause. • Good cause exists where the wholesaler failed to substantially comply with essential and reasonable requirements of the agreement, so long as those terms are not discriminatory.	Tenn. Code Ann. §§ 57-5-501 to 57-5-512; 57-6-104
Texas	• Written contract required. • Exclusive territories, filed with the State. • Termination upon 90 days' notice, with the wholesaler having 90 days to cure any deficiencies. • Immediate termination permitted upon a wholesaler's insolvency, conviction of a serious crime, loss of a license for 30 days or more, or failure to pay money when due, after demand. • Termination only for good cause. • Good cause means a failure to substantially comply with an essential, reasonable, and commercially acceptable term of the agreement.	Tex. Alco. Bev. Code Ann. §§ 102.51; 102.71 to 102.82
Utah	• Small brewers (manufacturers producing less than 6,000 barrels per year) exempted from franchise law. • Exclusive territories, filed with the State. • Written agreement required. • Termination upon 90 days' notice, with wholesaler given the opportunity to cure within 90-day period. • Immediate termination permitted for wholesaler's insolvency, conviction or a felony, loss of license for more than 30 days, or fraudulent conduct. • Good cause required for either brewer or wholesaler to terminate contract. • Good cause means the material failure to comply with terms that are essential, reasonable and lawful.	Utah Code Ann. §§ 32B-1-102; 32B-11-201; 32B-11-503; 32B-14-101 through 32B-14-402
Vermont	• Exclusive territories. • Termination upon 120 days' notice, with the wholesaler given 120 days to rectify any deficiency. • Immediate termination permitted upon a wholesaler's insolvency, or when the brewer shows that providing 120 days' notice would cause irreparable harm to the marketing of the brand. • Termination must be for good cause.	Vt. Stat. Ann. tit. 7, §§ 701 to 710

Virginia	• Exclusive territories (except where overlaps are caused by changes in brewer ownership), in writing and filed with the State. • Termination upon 90 days' notice and notice to the State, with a wholesaler given 60 days to provide the brewer with a plan for corrective action. • Immediate termination permitted in the case of a wholesaler's insolvency or loss of license. • Termination requires good cause. • Good cause is determined by the Virginia Department of Alcohol Beverage Control. • Good cause includes a wholesaler's loss of license, insolvency, or failure to substantially comply with reasonable and material requirements. Presumptively legitimate requirements include maintaining a brand's sales volume, providing services at a level comparable to that provided by other Virginia wholesalers, and requiring a brewer's reasonable consent to a transfer of the wholesaler's business. • Obligation of good faith is implied in every contract.	Va. Code Ann. §§ 4.1-500 to 4.1-517
Washington	• Franchise laws do not cover certain domestic suppliers producing fewer than 200,000 barrels of beer annually. • Written contract required. • Termination upon 60 days' notice, giving the wholesaler 60 days to cure any deficiency. • Immediate termination upon a wholesaler's insolvency, loss of license for more than 14 days, or fraud. • Wholesaler required to give a brewery 90 days' notice before termination.	Wash. Rev. Code §§ 19.126.010 to 19.126.901
West Virginia	• Written agreement, filed with the State. • Exclusive territories. • West Virginia must approve all new territorial appointments. • Distributor must be allowed to distribute new brands. • Termination upon 90 days' notice. • Termination must be for just cause.	W. Va. Code § 11-16-21
Wisconsin	• Parties must share a "community of interest" before "dealership" law applies. • Although the "dealership" provisions may not apply, Wisconsin law specifies the compensation due upon certain wholesaler terminations. • Written agreement required. • Exclusive territories required. • Termination upon 90 days' notice, with wholesaler given 60 days to rectify any deficiencies. • Termination upon 10 days' notice permitted where wholesaler is in default on payments under the agreement. • Immediate termination is permitted upon the wholesaler's insolvency. • Termination requires good cause. • Good cause includes the wholesaler's failure to substantially comply with essential and reasonable requirements of the agreement which are not discriminatory, or the wholesaler's bad faith acts.	Wis. Stat. §§ 125.33 to 125.34; 135.01 to 135.07

Wyoming	• Exclusive territorial agreements, filed with the State. • Termination upon 30 days' notice, during which time the wholesaler can cure with a plan to remedy deficiencies within 90 days. • Immediate termination permitted upon a wholesaler's insolvency, loss of license for 60 days or more, conviction of a felony, intentional sales outside the territory, or fraud. • Termination must be in good faith, and for good cause. • Good cause means wholesaler's insolvency, loss of license for more than 60 days, conviction of a felony, intentional sales outside its territory, or failure to comply with a reasonable and material provision of the franchise agreement. • Good faith requires honesty in fact and observance of reasonable commercial standards in the trade.	Wyo. Stat. Ann. §§ 12-9-101 to 12-9-119

Appendix 2

Summary of State Beer Self-Distribution Laws

State	License to Self Distribute	Statutory Citation
Alabama	No	Code of Ala. § 28-3A-6
Alaska	Yes	Alaska Stat. § 04.11.010
Arizona	Yes	A.R.S. § 4-205.08
Arkansas	Yes	A.C.A. § 3-5-1405
California	Yes	Cal Bus & Prof Code § 23357
Colorado	Yes	C.R.S. 12-47-402; C.R.S. 12-47-415
Connecticut	Yes	Conn. Gen. Stat. § 30-16
Delaware	No	4 Del. C. § 512C; Brewpubs at § 512B
District of Columbia	Yes	D.C. Code § 25-110
Florida	No	Fla. Stat. § 563.022
Georgia	No	O.C.G.A. § 3-5-32
Hawaii	Yes	HRS § 281-31
Idaho	Yes	Idaho Code § 23-1003
Illinois	Yes	235 ILCS 5/5-1; 235 ILCS 5/3-12

Indiana	Yes	Burns Ind. Code Ann. § 7.1-3-2-7
Iowa	Yes	Iowa Code § 123.124
Kansas	No	K.S.A. § 41-308b
Kentucky	No	KRS § 243.157
Louisiana	No	La. R.S. 26:273
Maine	Yes	28-A M.R.S. § 1355-A
Maryland	Yes	Md. Ann. Code art. 2B, § 2-208
Massachusetts	Yes	ALM GL ch. 138, § 19
Michigan	Yes	MCLS § 436.1401
Minnesota	Yes	Minn. Stat. § 340A.301
Mississippi	No	Miss. Code Ann. § 67-3-46
Missouri	No	§ 311.195 R.S.Mo.
Montana	Yes	Mont. Code Anno., § 16-3-214
Nebraska	No	R.R.S. Neb. § 53-169
Nevada	No	Nev. Rev. Stat. Ann. § 369.382
New Hampshire	Yes	RSA 178:12; RSA 178:12-a; RSA 178:13

New Jersey	Yes	N.J. Stat. § 33:1-10
New Mexico	Yes	N.M. Stat. Ann. § 60-6A-26.1
New York	Yes	NY CLS Al Bev § 51; NY CLS Al Bev § 52; NY CLS Al Bev § 64-c
North Carolina	Yes	N.C. Gen. Stat. § 18B-1104
North Dakota	Yes	N.D. Cent. Code, § 5-01-11; N.D. Cent. Code, § 5-01-14
Ohio	Yes	ORC Ann. 4303.02; ORC Ann. 4303.022; ORC Ann. 4301.24
Oklahoma	Yes	37 Okl. St. § 521
Oregon	Yes	ORS § 471.220; ORS § 471.200
Pennsylvania	Yes	47 P.S. § 4-431
Rhode Island	Yes	R.I. Gen. Laws § 3-6-1
South Carolina	No	S.C. Code Ann. § 61-4-940
South Dakota	No	S.D. Codified Laws § 35-8A-8
Tennessee	Yes	Tenn. Code Ann. § 57-5-101; Tenn. Code Ann. § 57-2-104
Texas	Yes	Tex. Alco. Bev. Code § 62.01; Tex. Alco. Bev. Code § 74.01 and 74.08
Utah	Yes	Utah Code Ann. § 32B-11-503

Vermont	Yes	7 V.S.A. § 230
Virginia	Yes	Va. Code Ann. § 4.1-208
Washington	Yes	Rev. Code Wash. (ARCW) § 66.24.244
West Virginia	Yes	W. Va. Code § 11-16-6; W. Va. Code § 60-4-3
Wisconsin	Yes	Wis. Stat. § 125.29; Wis. Stat. § 125.295
Wyoming	Yes	Wyo. Stat. § 12-2-201; Wyo. Stat. § 12-4-412; Wyo. Stat. § 12-5-401

Gaming, Gambling and Sweepstakes Law (Including Sports Gambling)

Submitted by Benjamin L. Bunker

GAMING LAW

A. Gambling Laws, Regulations, Permitting and Licensing

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A. Gambling Laws, Regulations, Permitting and Licensing

Federal Law

Gambling is legal at the federal level; however, interstate and online gambling are significantly restricted. The Interstate Wire Act of 1961 restricts gambling via interstate wire communications. The Unlawful Internet Gambling Enforcement Act of 2006 created added penalties for violations of the Interstate Wire Act.

Native American Gaming

American Indian reservations are areas where casino-style gambling may be found. The Indian Gaming Regulatory Act of 1988 ("IGRA") established Federal regulation of Native American gaming. Under the IGRA, revenue from gaming must provide for governmental operations, economic development, and the welfare of the tribe.

Under the IGRA, gaming is divided into three categories:

- Class I games – "Traditional" games that involve little or no wagering;
- Class II games – Bingo, pull-tabs, and certain non-banked card games (e.g., poker, cribbage, contract bridge, whist, etc.);
- Class III games – All casino games (e.g., craps, roulette, blackjack, baccarat, slot machines, and other games where the player bets against the house) and other games that do not fall into Class I or II.

The National Indian Gaming Commission has oversight of Native American gaming for the federal government. Gaming has been the most significant economic development tool available on Indian reservations.

State Gaming

Lotteries are legal in some form in every state except Hawaii and Utah. Most states have state-sponsored and multi-state lotteries.

Statewide casino-style gambling is *only* legal in Nevada and Louisiana. Other states allow casino-style gambling restricted to small geographic areas (e.g., Atlantic City, NJ, or Tunica, MS). In some states, casinos are restricted to "riverboats" that are typically permanently moored in a body of water.

B. Liabilities, Compliance and Enforcement

Nevada

Nevada Revised Statutes 463, et seq. governs licensing and control of gaming in the state of Nevada. NRS 463.022 created the Nevada Gaming Commission which is tasked with overseeing the licensing and while enforcement is governed by the Gaming Control Board.

The Nevada Gaming Control Board has an Enforcement Division that is its law enforcement arm and operates 24/7. The Enforcement Division's primary responsibilities are that of conducting criminal and regulatory investigations, arbitrating disputes between patrons and licensees, gathering intelligence on organized crime, making recommendations on possible candidates for the "List of Excluded Persons," conducting background investigations on work card applicants, and inspecting and approving new games, surveillance systems, chips and tokens, charitable lotteries and bingo.

C. Drafting Gambling Contracts

Gaming or Gambling Contracts are contract in which two parties agree to engage in a gamble, usually requiring wager for a chance to win money. Contracts related to gambling activities are normally only enforceable (if at all) where gambling is legal.

As a general rule, gaming contracts are unenforceable in Nevada. There are two exceptions to this rule: (1) casino debts evidenced by a credit agreement ("markers"); and (2) patron claims related to winnings from a game.

D. The Gaming Licensing Process

Nevada

Nevada has four tiers of licensing for gaming.

I. Gaming employees – Requires a two-page form, fingerprints and a small fee. The focus here is on the criminal history of the potential employee.
II. Special Gaming Employees – Requires a much longer application and a significant fee associated ($750). This requires a deeper investigation that the prior tier.
III. Restricted License – This is required for small establishments, such as taverns (15 or fewer slot machines). This requires an exhaustive application covering personal history and financial information. Agents from the Nevada Gaming Board will conduct a thorough criminal background check as well.
IV. Non-Restricted License – Casino operators and upper management typically are required to obtain a Non-Restricted License. This requires the most extensive background investigation. An applicant begins by filing a Multi-Jurisdiction Personal History Disclosure Form. This form is common in many gaming jurisdictions in the U.S. It contains two-parts: (1) 45-pages that focuses on the applicant's personal history, including his/her personal, familial, educational, marital, civil litigation, criminal, residential information,

employment history, licensing background, and character references; and (2) 20-pages that asks for financial information, tax information, bankruptcy disclosures, salary information, and a detailed statement of assets and liabilities.

An applicant must also file:

- A Nevada supplemental personal history disclosure form.
- A form releasing and indemnifying the regulators from any liability as a result of the investigation.
- A request to third parties such as banks or employers authorizing them to release information to the regulators.
- Fingerprint cards.
- An affidavit attesting that the applicant has made full disclosure on the forms.

E. Advising on Tax and Financial Questions

Nevada

Nevada taxes for gaming establishments is at an approximate 7.75% effective rate with a 6.75% tax on gross revenues and about 1% of taxes in fees. The tax revenue is directed into the state's general fund.

The Nevada Gaming Control Board issues its own Compliance Reporting Requirements that is included in these materials for reference and as an example. There are numerous auditing requirements for gaming licensees and strict reporting requirements in addition to the above. Due to the potential for fraud, Nevada closely monitors the financial reports for accuracy and compliance.

F. Fantasy Sports and Other Issues

Daily Fantasy Sports ("DFS") is a booming industry. On its face, it would appear that DFS could come under regulation by the Interstate Wire Act or its progeny. Federal law has not directly touched on DFS and as such it has been mostly left up to particular state law. The legality of DFS is based on a patchwork of state laws and Attorneys General opinions that vary dramatically.

Idaho, Texas, Alabama, Georgia, Hawaii, Illinois, and Nevada (must apply for gaming license) have outlawed DFS, typically by an opinion from the state's Attorney General. Other states, like South Dakota, Florida, Ohio, and Maryland, have left the issue unclear. Kansas, West Virginia, and Massachusetts AGs have come out clearly affirming the legality of DFS in their respective states while a majority of the remaining states otherwise allow DFS. https://www.legalsportsreport.com/daily-fantasy-sports-blocked-allowed-states/.

G. Protecting Intellectual Property

Gaming IP is essentially protected in the same manner as any other IP.

Trademarks

Trademark registration and protection through the US Patent and Trademark Office will be utilized by casinos, gaming technology companies, themed games/slot machines, and general gaming companies such as Daily Fantasy Sports, etc.

Patents

Patent protection is most often found in the game manufacturing sector, with one of the largest being International Game Technology PLC ("IGT"). Companies that design and manufacture gaming equipment will most readily require patent protection for their inventions.

Copyrights

Copyright protection is sometimes sought by game manufacturers for their software code.

Trade Secrets

An excellent catchall category for IP that cannot or should not be protected by other measures. The Defend Trade Secrets Act ("DTSA"), 18 U.S.C. §§ 1839, et seq., created a federal cause of action for the misappropriation of trade secrets. Confidentiality and/or Non-Disclosure Agreements are essential to taking full advantage of trade secret protection.

H. Sweepstakes, Contests and Promotions Law

Sweepstakes, contests, and promotions have the potential of turning into illegal gambling very easily. The formulas are as follows:

Prize + Chance + Consideration = an ILLEGAL lottery in all 50 states
Prize + Chance = Sweepstakes
Prize + Consideration = Contest of skill

Consideration can be either: (1) monetary (or purchase of product); or (2) non-monetary (expend more than nominal effort).

Legal Sweepstakes

To be legal, a sweepstakes must eliminate consideration or offer a free alternative means of entry ("AMOE"). The AMOE must have equal dignity with entrants giving consideration. Also, the AMOE must not itself be "consideration." Finally, the AMOE must be clear and conspicuous.

Legal Contest

A legal contest typically includes a prize and consideration, but must eliminate the element of chance. The winner of a legal contest must be selected based on a genuine skill. Additionally, a clear criteria and judges also strengthens the legality of a contest. If there is a tie, it must also be broken on the basis of skill, not a random drawing.

User-Generated Content Contests

User-Generated Contests invite consumers to post content (pictures, video, text, or music) and a sponsor or the public judges (or a combination thereof). Usually the content is either pre- or post- moderated.

If public judging is included, this would create a risk of chance, thereby transforming the contest into an illegal one. Some possible solutions are to limit the number of times the public can vote on an entry, limit public judging to a certain percent, and/or have the public judge on the same criteria as the expert judges.

Be cautious of re-publishing illegal content posted by contest entrants as it may violate copyright, be defamatory, etc. Utilize the DMCA "Safe Harbor" provision (17 U.S.C. § 512(c)), the CDA "Safe Harbor" (47 U.S.C. § 230), terms of use, and pre- and post-moderation to mitigate risks.

(This section was based on a CLE presentation by attorney Anne Moebes and she is a wealth of knowledge on this particular subject area of sweepstakes law).

NEVADA GAMING CONTROL BOARD

INTERNAL AUDIT COMPLIANCE REPORTING REQUIREMENTS

January 1, 2018

INTRODUCTION

"Internal Audit Compliance Reporting Requirements" are internal audit programs, checklists and guidelines developed to ensure that all gaming licensees who are required to provide for an internal audit function (i.e., Group I nonrestricted licensees and operators of interactive gaming) are performing a minimum amount and similar types of internal audit compliance procedures pursuant to Regulation 6.090(15).

The Internal Audit Compliance Checklists are designed to be used in conjunction with the CPA MICS Compliance Checklists and, therefore, do not separately address compliance with the Minimum Internal Control Standards (MICS). There are internal audit checklists for all gaming revenue areas, areas subject to entertainment tax, interactive gaming and for miscellaneous regulations.

The authority for the adoption of internal audit programs, checklists and guidelines can be found in Regulation 6.090(15) effective May 22, 2003.

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NEVADA GAMING CONTROL BOARD

INTERNAL AUDIT COMPLIANCE REPORTING REQUIREMENTS

GUIDELINES

Objectives

Regulation 6.090(15) requires the licensee's internal auditor to perform observations, document examinations and inquiries of employees to determine compliance with applicable statutes, regulations, and minimum internal control standards. The Board publishes checklists, programs, guidelines and example report formats for use in satisfying this regulatory requirement. The primary objective of these checklists, programs and guidelines is to provide guidance on what is necessary to comply with Regulation 6.090(15). A secondary objective is to provide some consistency among internal audit departments and other individuals performing internal audit work by standardizing the document examination sample sizes and the scope of the work to be performed. Standardized requirements ensure that all internal audit departments are performing a minimum amount of work and are performing the same required procedures. Finally, by standardizing the questionnaires and providing example report formats, the Board is able to review any internal auditor's workpapers in a more efficient and time saving manner without having to adjust to the myriad of internal audit department and accounting firm styles.

Each section contains a walk-through program and a testing program. Although the checklists are not to be considered all-encompassing, they address regulations adopted through January 1, 2018 and Minimum Internal Control Standards that became effective on January 1, 2018. As the requirements change due to the adoption of new regulations and/or statutes, internal auditors are expected to develop their own walk-through and/or testing procedures until updated versions of the checklists are distributed. Upon written notice by the Board Chairman or his designee, other procedures may be required. Additionally, these Guidelines are <u>not</u> intended to limit the internal auditor to the performance of only the above-specified procedures. If additional procedures are performed (e.g., expanded document testing), the results obtained should be included in the internal auditor's report pursuant to Regulation 6.090(15).

Requirement for Internal Audit Function

All nonrestricted Group I licensees, as defined in Regulation 6.010(5), are subject to these additional requirements and must provide for an internal audit function. A separate internal audit department, whose primary function is performing internal audit work and who is independent with respect to the departments subject to audit, is required to be maintained by licensees who meet either of the following criteria:

1. A single licensee having gross gaming revenue in excess of $10 million for the 12 months ended June 30; or

2. Two or more licensees with essentially common ownership and/or management having combined gross gaming revenue in excess of $10 million for the 12 months ended June 30.

   When determining the combined gross gaming revenue, include only those nonrestricted locations classified as Group I licensees. For example, the following two licensees have essentially common ownership and management:

   (Property 1) A Group I licensee with gross gaming revenues of $6.5 million;
   (Property 2) A Group II licensee with gross gaming revenues of $4 million;

   The licensees have combined revenues of $10.5 million, but would not be required to maintain a separate internal audit department.

For licensees who are not required to maintain a separate internal audit department, personnel who are independent with respect to the departments/procedures being examined perform internal audit work.

Separate Internal Audit Department

For those licensees required to maintain a separate internal audit department, this department's primary function is to perform internal audit work and is independent with respect to the departments subject to audit. Rather than using its own internal auditors, the licensee may elect to have the following individuals perform the internal audit function:

1. CPA (licensed by this state or another state or territory of the United States, who is qualified to practice public accounting in Nevada) other than the firm engaged to audit or review the licensee's financial statements pursuant to Regulation 6.080.

2. Another Individual (non-employee) - The licensee may elect to retain a non-employee individual, firm or business that does not hold a current CPA license described in #1 above.

3. Same CPA Performs Both Regulation 6.090(15) Internal Audit Procedures and Regulation 6.090(9) CPA Procedures – Pursuant to NRS 463.157, if the stock of the licensee or the stock of the licensee's parent company is publicly traded, the same CPA engaged to provide an audit, review, or compilation of the financial statements cannot also perform internal audit procedures. For other licensees, if the CPA is engaged to perform the internal audit procedures and Regulation 6.090(9) procedures, the required observations of the hard, soft and currency acceptor drop/count procedures must be separately performed to satisfy both these Internal Audit guidelines and the CPA guidelines.

   When the same CPA firm performs the procedures required by both Regulation 6.090(15) and Regulation 6.090(9), the individual(s) performing the Regulation 6.090(15) procedures cannot also perform the Regulation 6.090(9) drop and count procedures.

A qualified foreign internal audit department may perform branch office internal audit work under the direction of the Nevada internal audit director (e.g., Macau internal audit department performs internal audit procedures for branch offices). The licensee may also elect to utilize the MICS compliance work of the internal audit department to substitute for the CPA work required by Regulation 6.090(9). The licensee must submit written notification to the Board, and the internal audit department must satisfy specific criteria as addressed in the CPA MICS Compliance Reporting Requirements, for such utilization to be permitted.

Qualifications of Personnel Performing Internal Function

The internal auditor (includes employees and non-employees) assigned to perform the required procedures pursuant to Regulation 6.090(15) must be independent with respect to the departments subject to audit and must have:

1. A high school diploma (or equivalent) and two years of post-secondary education which includes the successful completion of 6 courses in accounting, finance, hotel administration or in any other business-related field, or have a minimum of 6 months gaming accounting/auditing experience; or

2. A minimum of 6 months of accounting/auditing experience with a CPA firm, or

3. If neither #1 nor #2 is satisfied, supervision of the internal auditor is provided by an auditor who meets the above requirements.

In certain limited circumstances an internal auditor may not satisfy the above criteria. For good cause, upon written request by a licensee, the Chairman or his designee may waive any of the preceding requirements.

Required Procedures

The internal auditor is required to:

1. Complete the applicable internal audit compliance walk-through procedures checklist by performing inquiries and observations during the period under review, and performing document compliance testing for dates within the period under review. An employee-completed questionnaire is not to be used to replace an in-person inquiry when performing compliance walk-through procedures. A separate checklist must be completed for each gaming revenue center, cage and credit departments, branch offices, information technology department, other miscellaneous regulations, interactive gaming operation and information technology for an interactive gaming operation. These checklists are used to determine if the licensee's procedures in effect and the documents in use comply with the MICS and applicable regulations.

   Walk-through checklists must be completed once during each fiscal year in all areas, except for slots and table games, and for branch offices once every two years or five years depending on the dollar amount of deposits and credit instrument payments in the branch office. Walk-through checklists for slots and table games are completed as follows:

   - *CPA MICS Compliance Checklist – All Procedures* for slots and table games is performed once during each fiscal year. Since the CPA and internal auditor will both perform a MICS compliance walk-through (All Procedures) during the licensee's business year, the internal auditor is not to perform these walk-throughs in the same six-month period as the CPA. This is applicable when the CPA does not utilize internal audit to substitute for CPA work.

   - When the CPA utilizes internal audit to substitute for CPA work in accordance with the CPA MICS Compliance Reporting Requirements, the internal auditor may perform MICS compliance for slots (including procedures for a Mobile Gaming System) and table games as follows:

     - MICS compliance walk-through – *General Walk-through - Limited Procedures Checklist* for one six-month period; and
     - MICS compliance walk-through – *General Walk-through - All Procedures Checklist* for the other six-month period.
     - MICS compliance walk-through – *General Walk-through - All Procedures Checklist* when the licensee (a new licensee or a licensee surrendering gaming license) operates the gaming area for a partial period of greater than three months and less than twelve months.

2. In addition to the above noted checklists, completion of the following "Other Slots Checklists" for a Mobile Gaming System are required to be performed as follows:

   - Internal Audit Compliance Checklist – Slot Walk-Through Procedures (for each six-month period)
   - Internal Audit Compliance Checklist – Slots Testing Procedures (for each six-month period)
   - CPA MICS Compliance Checklist – Slots – On-Line Slot Metering Systems (for each six-month period)
   - Internal Audit Compliance Checklist – Information Technology Walk-through Procedures (once during each fiscal year)
   - Internal Audit Compliance Checklist – Information Technology Testing Procedures (once during each fiscal year)
   - CPA MICS Compliance Checklist – Information Technology MICS #1 - #60 (once during each fiscal year)

   If reported annual gaming revenue for Mobile Gaming (a system based game) is less than $5,000, the internal auditor is only required to complete the procedures pertaining to a Mobile Gaming System in the "CPA MICS Compliance Checklist – General Walk-through – Limited Procedures" and in the "Other Slots Checklists" for one of the six-month periods. The performance of all procedures for a Mobile Gaming System in the "CPA MICS Compliance Checklist – General Walk-through - All Procedures" and the performance of all procedures for a Mobile Gaming System in the "Other Slots Checklists" will be considered sufficient for the licensee's business year for the Mobile Gaming System related procedures.

   Additionally, the performance of procedures in the aforementioned IT checklists pertaining to a Mobile Gaming System are to be performed once every two years if the reported annual gaming revenue for Mobile Gaming was less than $5,000.

   If the procedures for mobile gaming are limited as allowed in the previous two paragraphs, the internal auditor is required to prepare and maintain documentation, within 15 days following the end of the business year, supporting the fact that the reported annual mobile gaming revenue was less than $5,000 for the licensee's business year. The internal auditor will maintain this documentation in their work papers to support not performing procedures pertaining to a Mobile Gaming System as discussed above.

3. Except as noted below, completion of the *CPA MICS Compliance Checklist – Entertainment* is performed for all areas subject to entertainment tax once during the licensee's business year. NRS 368A.140 allows internal audit to perform procedures annually rather than every six months as indicated in NAC 368A.510(3)(b). The internal auditor is not required to complete this checklist for entertainment areas (includes special event venues) with annual live entertainment revenue of less than $5,000. Additionally, the internal auditor may complete the *CPA MICS Compliance Checklist - Entertainment* a minimum of once every two years for entertainment venues generating annual live entertainment revenue of less than 3% of total annual reported entertainment revenue.

   When the internal auditor performs less frequent reviews of certain areas subject to entertainment tax, as described in the previous paragraph, the licensee is required to prepare and maintain an entertainment revenue table at the end of the business year. The licensee is not required to prepare

a table when the internal auditor performs entertainment MICS compliance procedures in all areas subject to entertainment tax for the year under audit. The table will indicate the name of each area subject to entertainment tax, the annual reported entertainment revenue (projected annual entertainment revenue for any area not operated for a full business year) for the entertainment area, and the percentage of the area's entertainment revenue when compared to total annual reported entertainment revenue. The internal auditor will use this table for scheduling entertainment MICS compliance procedures to be performed in the upcoming licensee's business year in determining which areas of entertainment are subject to an annual review, a review once every two years, or possibly no review. This table is maintained with the internal audit workpapers to support the frequency of entertainment MICS compliance procedures performed for areas subject to entertainment tax.

4. An unannounced observation is performed twice during each fiscal year (once during each six-month period, and not within thirty days of each other) of each of the following: Slot coin drop, slot currency acceptor drop, table games drop, slot coin count, slot currency acceptor count, and table games count. During each observation, the related key controls are reviewed by completion of the applicable CPA MICS Compliance Checklist for key controls.

   The internal auditor may perform an unannounced observation of the slot coin drop and slot coin count a minimum of once a year when slot coin drop is less than 5% of the annual total combined slot coin and slot currency drop.

   When the internal auditor performs an observation of a slot coin drop and count once during the licensee's business year, as described in the previous paragraph, the licensee is required to prepare and maintain a document indicating the total slot coin drop and slot currency drop at the end of the business year. The licensee is not required to maintain this document when performing the slot coin drop and count observation once every six-month period for the year under audit. The document will indicate the annual amount of drop for coin and for currency and the combined coin/currency drop total; and the percentage of the drop when comparing to total combined drop. The internal auditor will use this document for scheduling the coin drop and count observation for the upcoming licensee's business year. This document is maintained with the internal audit workpapers to support the frequency of the slot coin drop and count observations performed during the licensee's business year.

5. Use the applicable internal audit compliance testing procedures checklist and perform substantive testing of each gaming revenue center, for areas subject to entertainment tax, cage and credit departments, branch offices, information technology department, tests for compliance with gaming regulations, interactive gaming operations and information technology for interactive gaming operations. These checklists are used to determine compliance with the MICS, regulations and statutes, and to determine if the licensee's recording and reporting procedures are adequate and accurate. There is a separate audit program that covers miscellaneous compliance walk-throughs and/or testing for other regulations, as well as license conditions, compliance committees and the Internet.

   Testing procedures must be completed for each six-month period of the licensee's fiscal year for the slot and table games departments, and for branch offices once every two years or five years depending on the dollar amount of deposits and credit instrument payments in the branch office. Testing procedures for all other areas need only be completed annually. Testing procedures

includes the selection of at least one test date during each review period. Additionally, where multiple test dates are required to be selected during a year, the test dates are not to be within thirty days of each other.

The internal audit procedures required by Regulation 6.090(15) are separate from the accounting/audit procedures required by the Regulation 6.090 Minimum Internal Control Standards (MICS). At times an accounting/audit procedure required by the MICS is also a similar audit procedure required by Regulation 6.090(15). When internal audit performs similar audit procedures required by both Regulation 6.090(15) and the MICS, the individual(s) performing the MICS procedure cannot also perform the similar Regulation 6.090(15) procedure. Additionally, the internal auditor is to confirm that any accounting/audit MICS procedures, performed by an internal auditor, are being properly performed.

The above procedures are the minimum procedures that must be performed for any gaming revenue center, interactive gaming operation or for areas subject to entertainment tax being operated for more than three months during the licensee's business year. The minimum procedures are not required to be performed for any of the aforementioned areas operated for three months or less during the licensee's business year.

When performing the preceding internal audit procedures for two or more properties sharing one gaming license and a common internal control system, the multiple properties are treated as one property. The procedures may be performed on a rotating basis between the properties. For example, the internal auditor may perform compliance procedures at one property this year and then perform the same compliance procedures at the other property next year.

Photocopies of the checklists provided by the Board may be used. However, if your checklists are generated from the Board's electronic files, the format must be identical to that originally issued by the Board. A change from portrait to landscape is not considered a change in format. When modifying checklists due to regulatory changes or the addition of explanatory notes, the acceptable method will be to note the change following the question/procedure (which remains worded as issued by the Board). Although copies of the checklists are expected, the Board may grant approval for other formats.

Do not use checklists for areas that are inapplicable to your operation. For example, if you do not offer keno, discard the keno checklists; do not mount unnecessary checklists in your workpapers and mark them "not applicable".

Upon written request by a licensee, the Audit Division may provide written approval to waive the performance of internal audit procedures in one or more areas of review for a specific year due to the occurrence of unusual circumstances, for good reason, or to extend report submission deadlines. The Board will consider waiving, on a case by case basis, specific internal audit compliance procedures where automated controls are determined to be in place and functioning effectively. Such approval is at the sole discretion of the Board. For new licensees, or for licensees that have surrendered their gaming license that were in operation for three months or less by the end of their business year, performance of these internal audit procedures is not required for the partial period. The Board classifies new licensees as Group I based on their first-year gross gaming revenue projections. Such initial classification should be used when determining whether recently licensed entities are required to maintain a separate internal audit department and/or comply with Regulation 6.090(15).

Performance and Completion

The internal auditor must perform and complete procedures in accordance with the following requirements:

1. All questions on each applicable checklist must be completed. Detailed explanations must be provided for all "no" and "N/A" responses and for exceptions noted during document testing.

2. Observations must be performed on an unannounced basis and, whenever possible, are to be performed without the employees being aware that their activities are being observed. For purposes of these procedures, "unannounced" means that no officers, directors, or employees are given advance information regarding the specific dates or times of such observations. Such observations may be performed from the surveillance room if practical. If advance arrangements for count room access are necessary between the licensee and the internal auditor, the arrangements indicating the method that will be used to allow the internal auditor access to the licensee's count rooms should be made no later than 90 days after the start of the licensee's business year. Documentation should be prepared by the internal auditor indicating the date the arrangements were made, the time period the arrangement is in effect, procedures to allow the internal auditor prompt access to the licensee's count room and the method to ensure proper identification of the internal auditor. These arrangements should allow the internal auditor prompt access to the count rooms at any time without prior notification to any licensee personnel. Any subsequent updates to these arrangements (e.g., personnel updates) should be made on a regular basis (e.g., quarterly) to avoid alerting the gaming operation of an upcoming observation.

   If the drop teams are unaware of the internal audit drop observations and therefore the count observations would be unannounced, the hard count and soft count rooms may be entered simultaneously. Additionally, if the slot currency acceptor count begins immediately after the table games count in the same count room, by the same count team, and using the same equipment, the currency acceptor count observation can be conducted on the same day as the table games count observation as long as the internal auditor remains until monies are transferred to the vault/cage and accepted into accountability. When these conditions do not exist, counts must be observed on separate days.

   Observations may be performed live using surveillance equipment. However, because the internal auditor must observe the count until the monies are transferred to the vault/cage and accepted into the vault/cage accountability, any change in viewing location (i.e., from the count room to the surveillance room) will necessitate reviewing the surveillance tapes for the time period during which the auditor was in transit.

3. The licensee's written system of internal control (the "System") must be compared by the internal auditor to the procedures being used in the licensee's casino operations. Regulation 6.090(13) requires the licensee to comply with its written system of internal control as it relates to compliance with the Minimum Internal Control Standards, variations from the Minimum Internal Control Standards approved pursuant to Regulation 6.090(8), and Regulation 14 associated equipment approvals. Accordingly, in completing the final procedures of the "CPA MICS Compliance Checklists", the internal auditor must compare the written system of internal control against actual control procedures in effect as they relate to compliance with the MICS, MICS variations, and associated equipment approvals.

4. The internal auditor performs compliance testing of various documents referred to in the CPA MICS Compliance Checklists and the Internal Audit Compliance Testing Procedures Checklists to determine compliance with the MICS, regulations, and statutes and to determine if the licensee's recording and reporting procedures are adequate and accurate. The scope of such testing is indicated on the checklist where applicable. When multiple test dates are required to be selected, the test dates must not be within thirty days of each other. The checklists and/or back-up workpapers must include documentation of the original document examined by either explicitly identifying the form(s) (e.g., document # of slot jackpot form) examined or including a copy of the document(s) examined.

   Note: An original document is the document maintained pursuant to Regulation 6.060 which may be an original document scanned or directly stored to unalterable media (secured to preclude alteration) as approved by the Board.

5. All exceptions resulting from internal audit work are investigated and resolved with the results of such being documented and retained for five years. Documentation should include the names of individuals and job titles with whom inquiries were made and how the investigation was conducted.

6. The results of internal audit work should be reported directly to the audit committee, if applicable, and to senior management/ownership personnel who are independent of the departments under review. Internal audit findings are properly communicated to the appropriate employees of the gaming operation. The results of internal audit work will not include the findings of any accounting/audit procedures performed by internal auditors, which are required to be performed by Regulation 6.090 Minimum Internal Control Standards.

7. When two or more persons perform the internal audit function as required by 6.090(15), a supervisory review is performed of the internal audit work by someone other than the individual performing the procedures being reviewed. The individual performing the review of the internal audit workpapers will initial or sign on the workpaper. For electronic internal audit workpapers, an electronic signature and date along with an audit certification page may be maintained evidencing a review of the electronic workpapers.

8. Follow-up inquiries, observations, and examinations are performed to verify that corrective action has been taken regarding all instances of noncompliance cited by internal audit, the Gaming Control Board and/or the independent accountant with the results of such being documented. The verification is performed within six months following the date such notification was transmitted to management. For branch office noncompliance, the verification is performed within one year following the date transmitted to management.

Report Submission Requirements

Two copies of the internal auditor's report identifying procedures required by the Board and any additional gaming-related compliance audit procedures not required by the Board (i.e., management request, Sarbanes-Oxley procedures), a reference to the applicable internal audit checklists completed, all instances of noncompliance noted (regardless of materiality), the review period, and senior management/ownership personnel responses to the noted noncompliance must be submitted to the Board. The testing procedures

results for the test date(s) selected during the licensee's fiscal year must be included in the internal auditor's report by at least the second-half of the business year's report. However, it is encouraged that testing results for test dates selected during the first-half of the year are included in the internal auditor's report for the first six-month period of the licensee's fiscal year. Additionally, regarding noted noncompliance, the report must describe all instances of procedural noncompliance (regardless of materiality) with the regulations, MICS or approved variations, and all instances where the licensee's written system does not adequately reflect the licensee's actual control procedures in effect as they relate to compliance with the MICS, MICS variations, and associated equipment approvals.

The internal auditor's first-half of the business year report is to be submitted to the Board within 120 days after the end of the first six months of the licensee's business year. The internal auditor's second-half of the business year report is to be submitted to the Board within 150 days after the end of the business year and separate from the CPA's Regulation 6.090(9) compliance report even though Regulation 6.090(15) and NAC 368A.510(3)(c) both allow the second-half internal audit report to be included in the CPA's Regulation 6.090(9) compliance report. All workpapers and reports must be completed and reviewed prior to the 120-day and 150-day deadline to submit such reports, so that workpapers supporting these reports will be complete and readily available for Board review immediately following the reporting deadlines.

Effective July 1, 2012, one hard copy report and one electronic copy report is to be submitted to the Board. Instructions for submitting these reports can be found on the Board's website at http://gaming.nv.gov.

For each instance of noncompliance noted in the internal audit compliance reports, the following information must be included:

1. The citation of the applicable Nevada Revised Statute, Nevada Gaming Commission and Nevada Gaming Control Board Regulation, or Minimum Internal Control Standard for which the instance of noncompliance was noted.

2. A narrative description of the noncompliance, including the number of exceptions and sample size tested.

3. Management's responses to the noted instances of noncompliance.

4. Instances of noncompliance determined to be immaterial may be disclosed as a separate section of the report. A table may be prepared indicating the type of audit (i.e., slots, keno, credit, etc.), MICS #, noted exception and reason noted exception is determined to be immaterial. A broad management response is acceptable for acknowledging the instances of all immaterial noncompliance.

5. Instances in which the written system of internal control does not reflect the actual control procedures in effect as they relate to compliance with the MICS, MICS variations, and associated equipment approvals.

Refer to the Example Report Formats section of this document for example reports that may be used, which will contain all of the information discussed above, for summarizing findings.

All completed checklists and supplemental workpapers must be retained for five years. The completed checklists should not be forwarded as a part of the report submitted to the Board.

Please contact the Board's Audit Division in Reno or Las Vegas if you require clarification of the preceding guidelines.

Example Report Formats

INDEX

REPORT	VERSION NUMBER	EFFECTIVE DATE
Internal Audit Regulation 6.090(15) Report Format:		
Example A - Prepared By Licensee's Internal Auditor (In-House Internal Auditor or Other Individual who is not a CPA)	8	January 1, 2018
Example B - Prepared By Licensee's Internal Auditor (CPA Firm)	8	January 1, 2018
Example Findings Report	8	January 1, 2018
Requirements for Summarizing Findings	8	January 1, 2018

INTERNAL AUDIT REGULATION 6.090(15) REPORT FORMAT

EXAMPLE A - PREPARED BY LICENSEE'S INTERNAL AUDITOR (IN-HOUSE INTERNAL AUDITOR OR OTHER INDIVIDUAL WHO IS NOT A CPA)

We have performed the procedures enumerated below, which are required by Regulation 6.090(15) of the Nevada Gaming Commission and Nevada Gaming Control Board in evaluating [name of licensee]'s compliance with the applicable statutes, regulations, and minimum internal control standards during the six-month period ended [date].

The procedures that we performed and our findings are as follows:

1. In accordance with the "Internal Audit Compliance Reporting Requirements" effective January 1, 20XX, we completed the following: [List of "Internal Audit Compliance Checklists" completed]

   We noted instances of noncompliance that have been included in _____to this report [or "list findings here"] [or we noted no instances of noncompliance]. **(Refer to the "REQUIREMENTS FOR SUMMARIZING FINDINGS")**

2. [If applicable, list additional procedures performed at the request of the Audit Committee, if applicable, Senior Management/Owners of the Licensee or the Nevada Gaming Control Board.]

   We noted instances of noncompliance that have been included in _____ to this report [or "list findings here"] [or we noted no instances of noncompliance].

[Signature]
[Date]

INTERNAL AUDIT REGULATION 6.090(15) REPORT FORMAT

EXAMPLE B - PREPARED BY LICENSEE'S INTERNAL AUDITOR (CPA FIRM)

Independent Accountants' Report On Applying Agreed-Upon Procedures

To the Audit Committee (if applicable) and Senior Management/Owners of ABC Company:

We have performed the procedures enumerated below, which are required by Regulation 6.090(15) of the Nevada Gaming Commission and Nevada Gaming Control Board (collectively the "Regulators"). These agreed-upon procedures are intended solely to assist ABC Company's management and the Regulators in evaluating ABC Company's compliance with the applicable statutes, regulations, and minimum internal control standards during the six-month period ended [date]. ABC's Company's management is responsible for ABC Company's compliance with the applicable statutes, regulations, and minimum internal control standards and published guidelines issued by the Regulators.

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures that we performed and our findings are as follows:

1. In accordance with the "Internal Audit Compliance Reporting Requirements" effective January 1, 20XX, we completed the following: [List of "Internal Audit Compliance Checklists" completed]

   We noted instances of noncompliance that have been included in _____to this report [or "list findings here"] [or we noted no instances of noncompliance]. **(Refer to the "REQUIREMENTS FOR SUMMARIZING FINDINGS")**

2. [If applicable, list additional procedures performed at the request of the Audit Committee, if applicable, Senior Management/Owners of the Licensee or the Nevada Gaming Control Board.]

   We noted instances of noncompliance that have been included in _____ to this report [or "list findings here"] [or we noted no instances of noncompliance].

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on management's compliance with the applicable statutes, regulations, and minimum internal control standards and published guidelines issued by the Regulators. Accordingly, we do not express such an opinion. Had we been engaged to perform additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the use of the Audit Committee (if applicable) and Senior Management/Owners of ABC Company and the Regulators and is not intended to be and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

[Signature]
[Date]

EXAMPLE FINDINGS REPORT

Fun Time Casino

Instances of Noncompliance Reported to Management by Internal Audit for the Six-Month Period Ended [Date]

Slots

Slot MICS #48 states: Drop boxes, when empty, are shown to another member of the count team, to another person who is observing the count, or to recorded or live surveillance, provided the count is monitored in its entirety by someone independent of the count.

During the observation of the currency acceptor count process at Fun Time Casino on September X, 20XX, we noted that on two occasions, one count team member showed the box to another count team member but did not receive acknowledgement that the box was empty. Additionally, inside of the box was not clearly visible to the surveillance cameras.

> **Management Response:** All count personnel have been reminded via a memorandum dated January X, 20XX, that it is required to have another team member visually verify the currency acceptor drop box is empty. Additionally, the soft count team members have been instructed to be very deliberate when showing the empty box and to clearly acknowledge that the box has been completely emptied.

Table Games

Table Games MICS #13 states: The issue slip includes the same marker number as the original, the table number, date and time of issuance, and amount of credit issued. The issue slip also includes the signature of the individual issuing the credit, and the signature or initials of the dealer at the applicable table, unless this information is included on another document.

During our detail testing, an examination of an issue slip (number XXXX) prepared on December X, 20XX, revealed that there was no time of issuance indicated on the slip.

This exception appears to be isolated. Thirty slips were reviewed for five test dates (10/16/XX, 10/23/XX, 11/07/XX, 11/29/XX and 12/5/XX) and only 1 out of the 30 slips prepared on December X, 20XX, did not indicate the time of issuance.

> **Management Response:** All table games personnel have been reminded via memorandum dated January X, 20XX, that the marker issue slip must include the date and time of issuance.

Keno

No exceptions were noted.

Cage and Credit

Cage and Credit MICS #73 states: An individual independent of the cage, credit, and collection functions performs the following review procedures at least three times per year:

a. Select a sample of credit accounts and ascertain compliance with credit limits and other established credit issuance procedures pursuant to Cage and Credit MICS #1 and Regulation 6.120(2).

A discussion with the accounting supervisor on September X, 20XX, disclosed that the aforementioned procedure has not been performed during the year 20XX. This is a recurring violation noted in the internal audit report for the period ended June 30, 20XX.

> **Management Response:** The accounting supervisor has completed this procedure for the year ended December 31, 20XX, as of January X, 20XX. The controller has reviewed the procedures performed to ensure the procedures were properly performed.

Miscellaneous Regulations

Regulation 3.100 Employee Report

Regulation 3.100 requires that the licensee submit a semi-annual report identifying every individual who is actively engaged in the administration or supervision of the operation as described by the regulation.

A discussion with the controller on September X, 20XX, disclosed that a semi-annual report was inadvertently not submitted for the period January 1, 20XX through June 30, 20XX.

> **Management Response:** The controller has submitted a Regulation 3.100 employee report for the period January 1, 20XX through June 30, 20XX to the Board on December X, 20XX.

REQUIREMENTS FOR SUMMARIZING FINDINGS

1. A separate report is prepared for each licensee. The report is to include the date submitted to the licensee.

2. Subdivide the findings/exception portion of the letter by type of audit (i.e., slots, keno, credit, etc.). Under each audit section list the exceptions noted from that audit. If no exceptions are noted, indicate this under the applicable audit heading. There should be an audit heading for each audit performed during the period coved by the letter, whether or not exceptions are noted.

3. Clearly state the basis for the exception (i.e., MICS # or regulation citation). Do **not** indicate the checklist procedure number as the basis for the exception. For exceptions noted for testing procedures performed without a MICS or regulation citation, indicate the specific procedure performed (not procedure number).

4. Indicate how the exception was discovered (i.e., interview with employee on (MM/DD/YY), observation on (MM/DD/YY), detail testing on (MM/DD/YY), etc.)

5. If the exception was discovered through observations of an employee performing his or her duties, indicate if the exception appears to be isolated or whether it is part of the employee's routine procedures.

6. If the exception was discovered through detail testing, indicate the sample size examined (i.e., number of days reviewed, number of forms reviewed, etc.) and the time period from which the sample was selected (i.e., second half of 20XX).

7. After each exception indicate the applicable management response and date of management's response. The management's response can be on a separate document as long as it is clearly referenced to the applicable exception. Each exception must be accompanied by a separate response. It is not acceptable to provide one management response addressing multiple exceptions, unless determined to be an immaterial exception as addressed in #11. This response should indicate specifically what procedures management has taken to correct the problem and the date such changes became effective.

8. If Internal Audit or the CPA previously cited the same exception within the current reporting period, a reference should be made to the date of the audit in which the exception was originally noted and whether Internal Audit or the CPA discovered it. The reasons for the repeated noncompliance should also be noted (i.e., management implemented change but employees subsequently reverted to incorrect procedures, etc.).

9. If Internal Audit or the CPA notes the same exception as the licensee's accounting/audit personnel through the normal course of their work, this exception is still documented and noted in the report. The internal audit or CPA workpapers and the report submitted to the Board indicate the corrective actions taken by the licensee when first notified by the licensee's accounting/audit personnel.

10. The exceptions noted (or lack of exceptions) may be in table form as long as the table contains all necessary information in the format indicated above.

11. Instances of noncompliance determined to be immaterial may be disclosed as a separate section of the report. A table may be prepared indicating the type of audit (i.e., slots, keno, credit, etc.), MICS # or regulation cite, noted exception and reason noted exception is determined to be immaterial. A broad management response is acceptable for acknowledging the instances of all immaterial noncompliance.

Checklists

Legal Ethics

Submitted by Gary K. Luloff

LEGAL ETHICS OF MARIJUANA, GUN, CRAFT BEER, WINE AND GAMBLING LAW

LEGAL MALPRACTICE RISKS BACKGROUND

- Federal marijuana law supersedes state law where there is a "positive conflict"
- The Controlled Substances Act criminalizes the manufacture, distribution, and dispensing of marijuana
- Current DOJ guidance rescinded lax enforcement policy
- Medical marijuana industry sheltered by Rohrabacher-Blumenauer Amendment

LEGAL MALPRACTICE RISKS
STANDARD OF CARE

Advise clients of:

- **The risk of prosecution under federal law**
- **The limitations of the advice-of-counsel defense**
- **The limitations of attorney-client privilege**
- **Tax implications**
- **Unavailability of bankruptcy relief**

LEGAL MALPRACTICE RISKS
MALPRACTICE INSURANCE

- **Legal malpractice insurance may exclude criminal acts**
- **Lawyers should carefully review their malpractice insurance policies before beginning marijuana-related representation**

ETHICAL STANDARDS AND CIVIL LIABILITY

- **Lawyer Ethics: Not an Oxymoron**
- **Model Rules of Professional Conduct**
- **States' Rules of Professional Conduct or Professional Responsibility**

ETHICAL STANDARDS AND CIVIL LIABILITY

ABA Model Rule 1.2(d)

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

ETHICAL STANDARDS AND CIVIL LIABILITY

Many states have modified their versions of Rule 1.2 or issued advisory opinions to allow attorneys to represent clients in compliance with state law, as long as they inform clients of conflicting federal law.

ETHICAL STANDARDS AND CIVIL LIABILITY

USING AND INVESTING IN MARIJUANA

- **Can an attorney use marijuana in a state where doing so is legal?**
  - **ABA Model Rule 8.4(b)**
- **Can an attorney invest in a marijuana business?**
  - **ABA Model Rule 1.8**

ETHICAL STANDARDS AND CIVIL LIABILITY
OTHER ETHICAL RULES

- **ABA Model Rule 1.1: Competence**
- **ABA Model Rule 1.2: Scope of Representation & Allocation of Authority Between Client & Lawyer**
- **ABA Model Rule 1.6: Confidentiality of Information**

ETHICAL STANDARDS AND CIVIL LIABILITY
CIVIL LIABILITY

- **Attorney negligence for imprudence**
- **Attorney as fiduciary**
- **Other civil and criminal penalties**

ETHICAL STANDARDS AND CIVIL LIABILITY

- **Majority courts: violation of ethical standards is evidence of attorney malpractice.**
- **Compliance with ethical standard may be defense to attorney malpractice.**

ATTORNEYS' FEES

- **Where can law firm deposit client funds?**
- **Can attorneys accept fees for marijuana-related representation?**

THE ROLE OF ATTORNEY AS ADVISOR IN ENTITY FORMATION

- **When does representation begin?**
- **ABA Model Rule 1.18**

ROLE OF ATTORNEY AS ADVISOR IN ENTITY FORMATION

WHO IS THE CLIENT?

- **Organization or entity as client**
  (LLC, Corporation)
- **Representation of individuals**
- **Representation of affiliates**

AVOIDING CONFLICTS OF INTEREST

- What is a conflict of interest?
- Who determines whether a conflict exists?
- Is there a conflict?

AVOIDING CONFLICTS OF INTEREST

- Who is the client?
- How is attorney-client relationship formed?
- Can the lawyer represent despite the conflict?
- What is concurrent representation and informed consent?

Legal Ethics of Marijuana, Guns, Craft Beer, Wine and Gambling Law

Submitted by Gary K. Luloff

MARIJUANA LAW

A. LEGAL MALPRACTICE RISKS

1. Background

Marijuana is a federally regulated Schedule I controlled substance under the Controlled Substances Act (the CSA), 21 U.S.C. §812(b)(l) and (c)(10). Under the CSA, it is a federal crime to "manufacture, distribute, or dispense" controlled substances. 21 U.S.C. § 841. The CSA classifies Schedule I drugs as those that have a "high potential for abuse" and "no currently accepted medical use," and for which there is "a lack of accepted safety for use of the drug or other substance under medical supervision." 21 U.S.C. 812(b)(1). While 21 C.F.R. § 1306.04 allows doctors to prescribe and pharmacists to dispense controlled substances for a "legitimate medical purpose," Schedule I controlled substances by definition have no such purpose. Therefore, under federal law, there is no legal use of marijuana, whether recreational or medicinal.

Of course, many states have enacted laws to de-criminalize marijuana for medicinal and/or recreational purposes. This conflict between state and federal law poses many challenges and potential pitfalls for lawyers who represent clients involved in the budding marijuana industry.

2. Is the client at risk of federal prosecution?

In short, yes. The Supremacy Clause of the U.S. Constitution dictates that federal law supersedes state law. While the CSA provides that it should not "be construed as indicating an intent on the part of Congress to occupy the field" to the exclusion of state law "unless there is a positive conflict" between the federal and state law so that "the two cannot consistently stand together," 21 U.S.C. § 903, many state marijuana laws do positively conflict with federal law. As long as federal law continues to criminalize the manufacture, distribution, and dispensing of marijuana, clients involved in the marijuana industry are not immune from federal prosecution. This is especially true under the current Department of Justice guidance, which rescinded the lax enforcement policy of the previous Deputy Attorney General James Cole. *See* Memorandum from James M. Cole, Deputy Att'y Gen., U.S. Dep't of Justice, for All U.S. Att'ys (Aug. 29, 2013).

Cole's formal guidance (known as the Cole Memorandum) directed that the prosecution of marijuana businesses complying with state law was not an enforcement priority. Upon rescinding the Cole Memorandum, Attorney General Jeff Sessions stated that "It is the mission of the Department of Justice to enforce the laws of the United States, and the previous issuance of guidance undermines the rule of law." *See* U.S. Dep't of Justice Press Release 18-8 (Jan. 4, 2018). It's worth noting that, even under the marijuana industry-favorable Cole Memorandum, clients weren't immune from risk. The Cole Memorandum applied only to criminal prosecutions, so clients remained at risk for civil monetary penalties, civil forfeitures, and regulatory sanctions.

The medical marijuana industry has been relatively sheltered from the tumult of changing prosecutorial policies. Since 2014, Congress has continually renewed and extended a provision in the Department of Justice appropriations bill (known as the Rohrabacher-Blumenauer amendment) that bars the use of federal funds to prevent implementation of lawful state medical marijuana programs.

3. Standard of care in advising clients

The special malpractice risks that arise in the context of marijuana-related representation relate to adequately advising clients of the conflict between state and federal law and the implications of this conflict. Although the scope of advice that will pass legal malpractice muster varies depending on a wide variety of factors, attorneys should take note of the following special considerations.

a. Advise clients of the risk of prosecution under federal law

Attorneys should make sure clients understand that even if they comply with state law, it's likely that their marijuana-related endeavors will violate existing federal law. While the risk of federal criminal prosecution may be slight, there are no guarantees of immunity from prosecution. It's important that clients understand the risks they are taking when they embark on a marijuana-related endeavor. Attorneys should outline the federal laws that the client is at risk of violating and the associated consequences.

Further, attorneys should note that even clients who are not involved first-hand in a marijuana business are at risk. Ancillary service providers, such as equipment dealers, packaging suppliers, and accountants, who knowingly serve a marijuana business may also be subject to harsh punishment under federal law as co-conspirators or aiders and abettors.

b. Note the limitations of the advice-of-counsel defense

On a related note, attorneys should advise clients that reliance on the attorney's advice will not always shield them from liability. While the advice-of-counsel defense negates the element of specific intent to commit a crime, not all federal drug statutes require proof of specific criminal intent. Some federal drug crimes require only that the person knew he was interacting with a marijuana business, even if he believed his actions were legal, based on the advice of counsel. Further, if a client raises the advice-of-counsel defense at trial, he waives the attorney-client privilege and the attorney could be called as a witness against the client. If the attorney properly advised the client that the actions violated federal law, the attorney's testimony could be especially harmful to the client's defense.

c. Note the limitations of attorney-client privilege

Invoking the advice-of-counsel defense isn't the only threat to attorney-client privilege. In fact, communications between the client and lawyer might not be privileged, regardless of waiver, if the communications are made with the intent of committing or furthering a crime. The crime-fraud exception applies even if the attorney had no knowledge of and did not participate in the crime. Because, for instance, operating a marijuana business is a crime under federal law, a prosecutor could subpoena an attorney that represents a marijuana business and force him to disclose the contents of communications with the client regarding the client's business operations.

d. Advise clients of tax implications

In order to satisfy the requirement of competence, an attorney must consider ancillary ramifications of an activity. For instance, the IRS does not recognize business expense deductions related to a trade or business trafficking in Schedule I or Schedule II controlled substances, which includes marijuana dispensaries. *See* 26 U.S.C. § 280E. The inability to deduct these expenses can significantly affect a client's business, so lawyers representing marijuana-related businesses should give clients early notice of this unfavorable tax law. AS a general caution, traps for the unwary can crop up when entering a new field of law, and it is wise to remember to stop, take the time to paly out scenarios, and attempt to discern where the pitfalls may be.

e. Advise clients of the risk of civil forfeiture and civil penalties

Apart from criminal prosecution, clients are also at risk of losing their assets to civil forfeiture. Pursuant to 18 U.S.C. § 981, the government can seize property—from bank accounts to real property to claw-back payments to vendors for services rendered—involved in marijuana-related transactions that violate federal law.

f. Advise clients that bankruptcy will not protect their business from creditors

Bankruptcy courts have uniformly declined to provide relief to companies and individuals that derive their income from the manufacturing, distributing, dispensing or possessing of marijuana, regardless whether the activity was sanctioned by state law. If a client's marijuana business fails, the client is unlikely to obtain bankruptcy relief.

4. Malpractice Insurance

As they say, you don't know what you have until you lose it. No lawyer wants to realize the value of malpractice insurance after coverage has been denied. Many insurance policies exclude criminal acts from coverage, and the exclusion could extend to acts that, while legal under state law, violate federal criminal law. Lawyers should carefully review their malpractice insurance policies and confirm with their insurers that coverage is available for claims that arise from marijuana-related representation.

B. ETHICAL STANDARDS AND CIVIL LIABILITY

1. Ethical implications of counseling and assisting clients in conduct that violates federal law

> *A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.*
>
> ABA Model Rule of Professional Conduct 1.2(d).

As discussed, marijuana sale or use, whether for medical or recreational purposes, is still illegal under federal law. A lawyer's ethical duty under Model Rule of Professional Conduct 1.2(d) continues even if the federal marijuana laws are not currently being fully enforced. This leaves attorneys few options for representing clients in compliance with the model rules, while the demand for marijuana-related legal services continues to grow. In response, many states have modified their versions of Rule 1.2, or the comments thereto, to address the tension between state and federal law. For example, Oregon's Rule 1.2(d) provides that "a lawyer may counsel and assist a client regarding Oregon's marijuana-related laws. In the event Oregon law conflicts with federal or tribal law, the lawyer shall also advise the client regarding related federal and tribal law and policy." In addition, may state bar associations have issued advisory opinions supporting the view that attorneys can represent clients in compliance with state law, as long as they advise clients of conflicting federal law. For example, in Minnesota, a state that has adopted a narrow medical marijuana law, the Lawyers Professional Responsibility Board issued an opinion stating that:

> A lawyer may advise a client about the Minnesota Medical Marijuana Law and may represent, advise and assist clients in all activities relating to and in compliance with the Law, including the manufacture, sale, distribution and use of medical marijuana, without violating the Minnesota Rules of Professional Conduct, so long as the lawyer also advises his or her client that such activities may violate federal law, including the federal Controlled Substance Act, 21 U.S.C. § 841(a)(1).

52 M.S.A., Lawyers Prof. Resp. Bd., Opinion 23.

The Minnesota legislature took the additional step of statutorily immunizing attorneys from disciplinary action by the Minnesota Supreme Court or professional responsibility board for providing legal assistance to prospective or registered manufacturers or others related to activity that is no longer illegal under the Minnesota Medical Marijuana Law. *See* Minn. Stat. § 152.32(2)(i).

Attorneys should check their state rules of professional conduct, state bar advisory opinions, and state statutes before providing legal advice related to the marijuana industry.

2. Ethics of attorneys using and investing in marijuana

Apart from advising clients on marijuana-related issues, attorneys might be interested in benefitting from state legalization of marijuana in other ways—namely, using marijuana for medical or recreational purposes, or investing in marijuana-related businesses.

ABA Model Rule of Professional Conduct 8.4(b) states that "[i]t is professional misconduct for a lawyer to … commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects." Alcohol and drug crimes are generally deemed to fall within Rule 8.4(b). However, the issue is not as clear cut when use of the substance is legal under state law. Some states that have considered the issue determined that marijuana use by an attorney in compliance with state law is not a violation of the ethical rules. For example, a 2012 Colorado ethics opinion stated that a lawyer's medical use of marijuana in compliance with state law "does not, in and of itself, violate [Rule 8.4(b)]"; there must be additional evidence that the conduct adversely implicates the lawyer's fitness. Colo. Ethics Op. 124 (2012). Other states have taken a contrary view. A North Dakota ethics opinion stated that an attorney who lives in Minnesota and is approved to use medical marijuana cannot be licensed to practice law in North Dakota. N.D. Ethics Op. 14-02 (2014). The attorney's participation in Minnesota's medical marijuana treatment program "would be unlawful and unethical" and "would constitute a pattern of repeated offenses that indicates indifference to legal obligations and constitutes a violation of [Rule 8.4(b)]." *Id*. (citations omitted). For those attorneys aspiring to the judiciary, note that it appears likely that judges won't be allowed to partake until federal law changes, regardless of the state.

A handful of states have addressed attorney investment into marijuana-related ventures. For example, a Maryland ethics opinion concluded that attorneys are not prohibited by the Rules of Professional Conduct from owning a business interest in a marijuana-related venture. Md. Ethics Docket No. 2016-10 (Feb. 29, 2016). *See also* Mo. Const. Article XVI, Section 1, Subsection 5(8)) ("An attorney shall not be subject to disciplinary action by the state bar association or other professional licensing body for owning, operating, investing in, being employed by, contracting with, or providing legal assistance to prospective or licensed Medical Marijuana Testing Facilities, Medical Marijuana Cultivation Facilities, Medical Marijuana Dispensary Facilities, Medical Marijuana-Infused Products Manufacturing Facilities, Qualifying

Patients, Primary caregivers, physicians, health care providers or others related to activity that is no longer subject to criminal penalties under state law pursuant to this section.").

However, if the investment opportunity involves a business transaction with a client, the standard rules relating to business transactions with clients should be observed. *See* ABA Model Rule of Professional Conduct 1.8.

3. Other ethical rules

- **Model Rule 1.1**: Model Rule 1.1 provides that a lawyer must provide competent representation, which "requires the legal knowledge, skill, thoroughness and preparation necessary for the representation." As discussed earlier, a lawyer's duty to be aware of the conflict between state and federal law is of paramount importance in properly advising clients.
- **Model Rule 1.2**: It is also important to clearly define the scope of representation. Attorneys face little risk of criminal liability for simply providing legal advice, but once the lawyer's services extend beyond advice, the lawyer may become an aider and abettor of an illegal drug enterprise. Attorneys and clients should agree on the appropriate scope of representation for the best interests of each.
- **Model Rule 1.6**: While attorney-client communications are generally confidential, there are a number of exceptions to the rule. For example, lawyers may disclose information relating to representation of the client to the extent necessary "to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services," "to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved," or "to comply with other law or a court order." *See* Model Rule 1.6(b)(2), (b)(5) and (b)(6). Along similar lines, as noted above, the crime-fraud exception might also render attorney-client privilege moot.

4. Civil liability

The Model Code of Professional Responsibility, created by the American Bar Association, sets forth ethical rules to guide lawyers in their behaviors and to provide a process of discipline for those who act improperly. Although language prefacing the ethical rules indicates that such rules are not to be used to impose civil liability upon violators, the majority of courts hold that evidence of an ethical violation is admissible evidence in a malpractice action.

The rules were created to establish a minimum level of competency and any actions falling beneath that minimum are evidence that the required standard of care required was breached. Therefore, evidence of an ethical violation can be used to demonstrate that the attorney breached the standard of care owed to its client. However, an ethical violation by itself will not establish a cause of action, but rather, it may be used as "some evidence" of malpractice.

However, as described in Section A, an attorney may also be sued for numerous other violations, other than just ethical violations. One common cause of action that is presented in legal malpractice claims is a claim for negligence. To be successful, the client must establish that the attorney took some type of action that a prudent attorney would not have taken, or that the attorney failed to take some type of action that a prudent attorney would have taken. Negligence can arise in various ways, such as giving incorrect advice, failing to file documents, or the creation of a conflict of interest.

Another claim that may be brought against an attorney is for breach of fiduciary duty. When an attorney enters into an attorney-client relationship, the attorney becomes a fiduciary of the client, owing the client a duty of utmost good faith. Such good faith requires the attorney to place the client's interest before his or her own interests, and prohibits the attorney from using his position to gain a profit at the expense of the client. In a business situation, a breach of fiduciary duty often arises if the attorney has a relationship or history with one of the parties to the transaction. Typically, when a corporation hires an attorney, an officer chooses an attorney that he or she knows or is familiar with. However, the attorney must remember that its fiduciary relationship is with the company and not the individual. As such, the attorney must do what is best for the company, even if it is not in the best interest of the officer or person whom the attorney has a relationship with.

Another area that is increasingly becoming an area of concern is when attorneys invest in the business of the client. When this occurs, the attorney still keeps its fiduciary relationship with the client and therefore, must put the interest of the business first, even if it is to the detriment of the attorney's investment. For example, an attorney may need to advise its client to file bankruptcy, even knowing that he or she will lose the investment in the company. This inherently creates an ethical issue and opens the attorney up to malpractice claims.

Finally, it's important to note that the threat of malpractice litigation is not the only risk the attorney takes when accepting a client involved in the marijuana industry. Many of the same

civil and criminal penalties that affect clients and ancillary service providers also affect attorneys. For instance, attorneys' fees derived from a marijuana business are subject to forfeiture as long as the attorney knew the funds came from an illegal source.

C. ATTORNEYS' FEES

1. Where can law firm deposit client funds?

Most states require certain client funds to be held in a depository account, however attorneys might find themselves in the same tough spot as their clients when searching for a bank in which to deposit marijuana-derived funds. Federal law makes it illegal to knowingly provide banking services for the proceeds of unlawful activities, including marijuana businesses. *See* 18 U.S.C.§ 1956. Further, both federal- and state-chartered financial institutions are often subject to heavy regulation and examination by the Federal Reserve. While the number of banks and credit unions willing to serve marijuana businesses continues to grow as the industry expands, the risks and regulatory burdens of serving the marijuana industry will likely continue to hold many banks back. See Marijuana Banking Update, FinCEN (December 2018), https://www.fincen.gov/sites/default/files/shared/Marijuana_Banking_Update_Public_Dec_2018.pdf.

2. Can attorneys accept (and keep) fees for marijuana-related representation?

Like banks, attorneys are at risk of violating federal money laundering laws when they transact with clients who are involved in the marijuana industry. For instance, attorneys who knowingly receive payment of more than $10,000 from a marijuana business may be subject to criminal penalties, including monetary fines and up to 10 years in prison. 18 U.S.C. § 1957. Attorneys who accept payment from the proceeds of a marijuana business with the intent to promote the carrying on of the marijuana business could find themselves charged with a federal crime punishable by up to 20 years in prison, along with hefty civil and criminal penalties. 18 U.S.C. § 1956. Further, any property involved in a transaction that violates § 1956 or § 1957 is subject to forfeiture to the U.S. government. 18 U.S.C. § 981(a)(1)(A). And, although § 1957 has a safe harbor provision that protects attorney's fees, it applies only to transactions necessary to preserve a person's right to representation as guaranteed by the Sixth Amendment—that is, representation of a client in a criminal proceeding.

In additional, lawyers may be subject to civil and criminal penalties, including monetary fines and imprisonment, for failure to report cash transactions that exceed $10,000. 31 U.S.C. § 5321, 5322. Because marijuana businesses often operate primarily in cash, lawyers should be prepared to comply with all necessary reporting requirements. Although attorneys' fees are a step removed from the operation of a marijuana business, attorneys may still have difficulty finding a bank willing to accept deposit of the criminally-derived funds.

D. THE ROLE OF ATTORNEY AS ADVISOR IN ENTITY FORMATION

> *In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.*

- "Advisor": Rule 2.1 of the Model Rules of Professional Conduct

The Model Rules define the role of the attorney as threefold: "A lawyer as a member of the legal professional, is a representative of clients, an officer of the legal system, and a public citizen having special responsibility for the quality of justice." When a lawyer is initially contacted to provide advice in connection with an emerging brewery or distillery business—for example, to establish or form an entity for that business—threshold questions arise: what will be the lawyer's role, when does representation begin, and who is the client?

1. When Does Representation Begin?

An attorney-client relationship can form long before a retainer agreement is signed. In Minnesota, an attorney-client relationship can form under a contract or tort theory. Under the contract theory, "[a] contract for legal services can be express or implied from the conduct of the parties." *Id*. Under the tort theory, "an attorney-client relationship is created whenever an individual seeks and receives legal advice from an attorney in circumstances in which a reasonable person would rely on such advice." *Togstad v. Vesely, Otto, Miller & Keefe*, 291 N.W.2d 686, 693 n.4 (Minn. 1980). The risk of unintentionally creating an attorney-client relationship may increase under the informal circumstances of working with a start-up. Lawyers should exercise caution when discussing legal matters with start-up founders, entrepreneurs, and professional or social acquaintances in informal settings. The unintended creation of an attorney-client relationship can impose duties on the attorney and expose the attorney to malpractice liability and discipline.

It should come as no surprise to lawyers who regularly interact socially with entrepreneurs and business people that there are times when these people can misunderstand the depth, or even existence, of an "attorney-client" relationship. It is a good idea to periodically remind oneself of the scope of Model Rule 1.18, which addresses this issue. In part, Rule 1.18 states:

> (a) A person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.
>
> (b) Even when no client-lawyer relationship ensues, a lawyer who has learned information from a prospective client shall not use or reveal that information, except as Rule 1.9 would permit with respect to information of a former client.
>
> (c) A lawyer subject to paragraph (b) shall not represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer received information from the prospective client that could be significantly harmful to that person in the matter, except as provided in paragraph (d). If a lawyer is disqualified from representation under this paragraph, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter, except as provided in paragraph (d).

All lawyers should have a letter available that advises a person who might fall under the category of a "prospective client" that, when no representation is truly consummated, informs the prospective client that the lawyer is not now, nor have they ever been, the lawyer for that prospective client.

2. Who is the Client?

As is the case with any business, when working with a brewery or distillery, it is crucial for the lawyer, the business, and the principals that the lawyer identify the client. For example, if the lawyer is retained to form an entity, such as a limited liability company (LLC) or corporation, the attorney must clearly identify who he or she represents: the entity, one or more of the principals, or some or all parties. Failure to do so at the outset is a common mistake lawyers make, which may have adverse consequences, not only for the lawyer, but more important, for the client(s) he or she represents.

When an entity is involved, there is a question of whether the lawyer represents the entity as a whole or one of the particular members. At first glance, rules of professional conduct appear to draw a bright line in entity representation. Rule 1.13(a) of the Model Rules, "Organization as Client" provides: "A lawyer employed or retained by an organization represents the organization

acting through its duly authorized constituents." This general principle is also made clear by the courts. *See, e.g.*, *Manion v. Nagin*, 394 F.3d 1062, 1068 (8th Cir. 2005) (corporate employee does not generally enjoy an attorney-client relationship with corporate counsel); *see also Humphrey v. McLaren*, 402 N.W.2d 535, 540 (Minn. 1987) (in representing a corporation against one of its officers or employees, corporate counsel's "allegiance is to the organization").

The Comment to Minnesota Rule 1.13 clarifies the meaning of the words "duly authorized constituents." For corporations, this term refers to "officers, directors, employees, and shareholders." For non-corporate entities, the term encompasses those individuals holding "the position equivalent to officers, directors, employees, and shareholders." In the case of an LLC, the equivalent positions are those of the employees, members, managers, and governors. Because the lawyer must consider each of these subgroups, conflicts of interest issues may arise. This is further explored in Section C.

a. Organization as the Client

A limited liability company is a creature of statute. Under Minnesota statute, for instance, an LLC is a legal entity that is separate and distinct from its partners. *See Opus Corp. v. International Business Machines Corp.*, 956 F. Supp. 1503, 1508 (D. Minn. 1996). Thus, when a lawyer or firm represents a business entity, the client is the entity alone, and not the members, managers, partners, etc. *Id*.

When members of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. The organization must make its own decisions concerning policy and operations, including those decisions entailing serious risk. However, there are certain situations where it may be appropriate for a lawyer to take action. If a lawyer for an organization learns that an officer, employee, or other person associated with the organization is engaged in action or intends to act in a manner that is a violation of a legal obligation to the organization or a violation of law that can reasonably be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. Minn. R. Prof. Conduct 1.13(b). In determining how to proceed, the lawyer should give due consideration to:

(1) the seriousness of the violation and its consequences;

(2) the scope and nature of the lawyer's representation;

(3) the responsibility in the organization and all the apparent motivation of the person involved;

(4) the policies of the organization concerning such matters; and

(5) any other relevant considerations.

Id. Any measures taken by an attorney must be designed to minimize disruption of the organization and to minimize the risk of revealing information relating to the representation to persons outside the organization, or even persons within the organization. *Id*.; *see also Opus*, 956 F. Supp. at 1508. In addition to informing individuals of the consequences of an adverse action or potential conflicts, measures taken to dissuade a member from acting in a manner that could substantially injure the organization may include:

(1) asking for reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to a higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

Minn. R. Prof. Conduct 1.13(b). The higher authority referred to could be the board of directors or a similar governing body. In addition, the stated policies of an organization may define circumstances and prescribe channels for review. If they do not, a lawyer should encourage the formulation of such a policy. At some point it may be useful or essential to obtain an independent legal opinion. A "taking it upstairs" contingency plan protects both the lawyer and the organization.

The comments to Rule 1.13 indicate that clear justification should exist for seeking review over the head of the member normally responsible for the organization. Care must be taken to assure that the individual understands that when there is such adversity of interest the lawyer for the organization cannot provide legal representation for the individual. In addition, discussion between the lawyer for the organization and the individual may not be privileged. Whether the lawyer should give a warning to the organization regarding an individual will be extremely fact-dependent and will turn on the specific facts of each case.

b. Representation of Individuals

In dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a lawyer must explain the identity of the client when it appears that the organization's interests are adverse to those of the individual's. Minn. R. Prof. Conduct 1.13(d). Nonetheless, a lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to the consent provisions of Rule 1.7. If the organization's consent to dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Issues arise when a number of individuals wish to form an entity and one of the individuals is the lawyer's original client. If the lawyer has been selected to draft the entity agreement for all the parties, it is important for the lawyer to clearly identify who is the client and for all parties to have an understanding of whether the lawyer represents the individual or the entity. Where the lawyer will represent the entity, it is then perhaps even more important not to appear to favor the original client, and for the original client to understand that the lawyer's commitment to professionalism will not permit favoritism.

In *Opus Corp. v. International Business Machines Corp.*, 956 F. Supp. 1503 (D. Minn. 1996) a law firm represented IBM in the formation of a partnership with another company. After the partnership was formed, the firm assumed the role as the partnership's counsel, as well as continuing to represent IBM in IBM's capacity as general partner and as an investor in the partnership. In this latter capacity, the firm represented IBM, on certain occasions, in a manner that was adverse to the interests of the other corporate partner. Difficult issues arose relating to attorney-client privilege during subsequent litigation between IBM and its corporate partner. These issues could have been avoided if the firm had been more observant about representing the partnership and one of its corporate partners.

A lawyer for an organization is not barred from accepting representation that is potentially adverse to the organization. However, attorneys have to be wary about providing advice to employees of the entities they represent. In *Manion v. Nagin*, an attorney agreed to represent an individual in creating a business. 394 F.3d 1062 (8th Cir. 2005). The individual later became a majority shareholder, and the attorney continued to represent the business. The attorney eventually provided the shareholder with advice about his personal interest in the company and its

management structure. The court indicated that this behavior was beyond the scope of the attorney's job as the company's attorney, and perhaps contrary to it. *Id*. at 1069.

If the attorney was truly working exclusively as the entity's lawyer, he should have responded to the shareholder's personal questions by clarifying the fact that he worked only for the company and he should have suggested that the individual seek outside counsel. *Id*. (citing Minn. R. Prof. Conduct 1.13(d), which requires corporate counsel who is dealing with a shareholder or employee to "explain the identity of the client when it appears that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing"). The individual advice given by the attorney was sufficient to establish that an attorney-client relationship existed. *Id*. at 1069. However, the shareholder was unable to state a claim for relief, or else the attorney could have been held liable for malpractice, breach of contract, or some other legal claim.

c. Representation of Affiliates (Parents or Subsidiaries)

Issues also arise when an entity is an affiliate of another entity, such as a parent or subsidiary corporation. While not common for start-up breweries, it is important to have an understanding of the ethical considerations and legal implications as part of the overall business plan and portfolio. Other entity relationships may be more likely in the brewery business, particularly where there may be state-law issues related to independent ownership of facilities, retailers, distributors, or other related activity. For example, a group of people might wish to form a brewing company and own the real estate or physical assets under a different structure, perhaps with some additional partners. It is not difficult to see that the everyone is on the same page now, but in the future the lawyer could end up representing the landlord and the tenant in a property dispute. Planning ahead for this, with the understanding that the lawyer will not be able to represent both parties, and probably not either party, if the interests diverge, is important, and the clients need to be aware of this, preferably in writing as memories fade, at the outset. In states where a brewer cannot have a retail presence, family members might be able to own the customer-facing business event though the brewer cannot. It does not take an active imagination to recognize that if this is a married couple, a divorce can pose serious issues and, perhaps to the ultimate benefit of the lawyer, the situation will result in a serious enough conflict to require the complete recusal of the attorney. A more fluid concept of affiliates and the possibility of traps for the unwary is likely a good thing to keep in mind.

Where there is a formal affiliate/parent relationship, a lawyer who represents a parent organization does not necessarily represent any affiliated organization. Minn. R. Prof. Conduct 1.13(a). Indeed, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated manner, unless:

(1) the circumstances are such that the affiliates should also be considered a client of the lawyer;

(2) there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates; or

(3) the lawyer's obligations to either the organizational client or the new client are likely to limit materially the lawyer's representation of the other client.

In *Bieter Co. v. Blomquist*, 132 F.R.D. 220 (D. Minn. 1990), the court found that a law firm was not disqualified from representing a shopping center developer in its action for alleged interference with its relationship with a prospective tenant even though the firm represented a different joint venture in a similar matter. The defendants were constituents of the joint venture during contract negotiations with the tenant, so they requested that the firm be disqualified from representing the plaintiff. However, the court held that the constituents of the joint venture were not clients of the firm, only the joint venture was. *Id*. at 225. Therefore, disqualification was not necessary. *Id*.

Common Mistakes Summarized

For reasons discussed above and in more detail in the next section, it is paramount for the lawyer to identify at the outset who the client is, specifically when an entity is involved. Failure to do so may result in unintended representation and expose the attorney to conflicting duties to multiple clients. This may require the lawyer to withdraw from representing all parties, which could be problematic legally and practically for all involved.

E. AVOIDING CONFLICTS OF INTEREST: WHO IS THE CLIENT?

The dreaded "conflict of interest." While it is a common phrase in the practice of law, it is also commonly misunderstood. Conflicts cannot only limit a lawyer's or law firm's ability to take on new clients, but also the prospective client's choice of counsel. And, if a conflict is not detected, determined or handled properly, it can lead to more drastic consequences, including attorney discipline and professional malpractice.

1. Conflict of Interest: What Is It?

A conflict of interest can be a serious ethical concept and dilemma for attorneys seeking to retain and advise clients. A conflict of interest occurs when an individual lawyer or law firm represents multiple clients (i.e., two or more) whose goals or requests (i.e., interests) are at odds with each other. This is also known as "concurrent representation." The most blatant conflict of interest or obvious form of concurrent representation exists when a lawyer or law firm represents both the plaintiff and defendant in a lawsuit or both parties to a contract. Most conflicts are not so obvious.

The ABA has created, and all states have adopted, ethical rules and guidelines to help lawyers identify and prevent conflicts. For example, Minnesota Rule of Professional Conduct 1.7 states that a lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

(1) the lawyer reasonably believes that the representation will not adversely affect the relationship with the other client; and

(2) each client consents after consultation.

In addition, a lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

(1) the lawyer reasonably believes the representation will not be adversely affected; and

(2) the client consents after consultation.

Id. When representation of multiple clients in a single matter is undertaken, the consultation must include explanation of the implications of the common representation and the advantages and risks involved. It is at the least a good practice to inform clients, at the outset, that they have a right to obtain their own counsel and should do so if they feel that there is too deep a conflict.

2. Conflicts Check: Who is the Client?

Before a lawyer and a potential client enter into an attorney-client relationship, the lawyer and his/her law firm must determine that the lawyer is not "conflicted" from representing the potential client. Typically, lawyers and law firms perform a "conflicts check," which generally involves reviewing the lawyer's and law firm's list of clients and matters to determine whether the lawyer and his/her firm represents (or represented) any party that has interests that are adverse to

the potential client's interests. A conflict check, however, is more than that and should involve a comprehensive system and database that is consistently conducted in a series of steps.

The first step in performing a conflicts check is to properly identify the potential client. As discussed in the preceding Section, if a lawyer is contacted by the organizer(s) of the business, the actual client may appropriately be the organization or entity, not the organizers or the directors, officers, or other constituents. The proper identity of the client must not only be determined by the lawyer at the outset, it must be adequately explained to the organizers. Model Rule 1.13(a) states "A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents," and "[i]n dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing."

This may be easier said than done. A lawyer does not talk to the entity, but deals with its authorized constituents (i.e., the principals, directors, officers). These individuals will personally feel a bond, or at least a relationship, with the attorney that an entity cannot feel. In addition, at the time formation is in progress, the organization or entity does not exist, and the lawyer must make the required explanation regarding when the entity's interests are or may be adverse to the constituents' interests. In these situations, it is best for the lawyer to put this explanation in writing to avoid any dispute as to whether the explanation was ever provided.

Again, in performing a conflict check, the lawyer is seeking to determine whether he or she is able to represent the potential client. If retention by the potential client would result in concurrent representation, then there is a conflict of interest that must be dealt with.

3. Conflicts Check: Identifying Sources of Conflict

The next step in guarding against conflicts of interest is to identify all potential sources of conflicts. Intake forms are useful to inquire about all parties related, including adverse parties and their counsel. Further steps are recommended to compare information on new matters with information on matters other individual attorneys, and the firm as a whole, have handled for other clients. Lawyers should perform a new conflict screen whenever additional parties join during representation.

According to the Comment to Minnesota Rule 1.7, the relevant factors in determining whether there is a potential for adverse effect include:

(1) the duration and intimacy of the lawyer's relationship with the client or clients involved;

(2) the functions being performed by the lawyer;

(3) the likelihood that actual conflict will arise; and

(4) the likely prejudice to the client from the conflict if it does arise.

Even non-direct conflicts of interest should be recognized if a lawyer's ability to consider, recommend, or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities of interest. Substantial risk that a conflict could interfere with the lawyer's independent professional judgment is the basis for this determination.

4. Concurrent Representation

If a potential concurrent conflict of interest exists, a lawyer is not automatically disqualified from representing the potential client. Model Rule 1.7(b) provides:

> Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
> (2) the representation is not prohibited by law;
> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
> (4) each affected client gives informed consent, confirmed in writing.

In other words, a potential client has the option of consenting to the concurrent representation notwithstanding the conflict. Importantly, this consent must be confirmed in writing by <u>each client</u>. A writing by the attorney identifying the conflict does not replace the lawyer's responsibility to talk directly with the client and explain the risks and advantages to the representation in addition to the burden of the conflict on the client and available alternatives. *See, e.g.*, Minn. R. Prof. Conduct 1.0. A lawyer, however, cannot ask for consent if a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances. For example, in situations where the clients are hostile, it would be unlikely that the lawyer could be impartial between the clients.

Common Mistakes Summarized

Conflicts of interest are difficult dilemmas to identify and deal with. It is not uncommon for lawyers and law firms to overlook a conflict of interest prior to the formation of an attorney-

client relationship. This failure commonly results from lawyers either misidentifying the appropriate client or failing to perform a systematic "conflicts check." It is also problematic when a lawyer fails to make clear to a business organization's constituents that the entity, not the constituents, is the client, particularly so if this explanation is not provided in writing. Although the Rules of Professional Conduct do not automatically disqualify a lawyer from concurrently representing clients, lawyers must guard against mistakenly failing to provide informed, written consent to all clients whose interests are presently or potentially adverse.

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