

## Getting Comfortable With Cannabis – Will Your Money Go Up In Smoke?

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### Client Advisory

June 13, 2019 by Guy P. Lander, Alexander G. Malyshev and Matthew J. Schwartz

Cannabis is a hot new industry. With it comes an investment landscape that, as with other new industries, is susceptible to illicit investment schemes.[1] Layer in the uncertainty of disparate state and federal laws and regulations, and it's easy to see why conservative investors are hesitant to put money into the cannabis industry. Despite the various factors dissuading potential investors, the promise of profits in a growing industry has led to an influx of money from small investors all the way up to institutional investors.[2]

Part I of this article explains the basics of what cannabis is, the difference between marijuana and hemp, what the cannabis extracts commonly referred to as THC (delta-9-tetrahydrocannabinol) and CBD (cannabidiol) are, and the laws and regulations relating to cannabis. Part II of this article provides a brief overview of the investment opportunities available in the cannabis industry.

### I – A Brief Introduction to Cannabis

#### *What is Cannabis?*

Cannabis is a plant belonging to the Cannabaceae family and containing a variety of biologically active chemical compounds.[3] Hemp and marijuana are both varieties of cannabis, though “cannabis” is often used interchangeably with “marijuana.” The distinction between hemp and marijuana is the concentration of THC, a psychoactive compound. Hemp (sometimes referred to as “industrial hemp”) contains no more than 0.3% THC on a dry weight basis, while marijuana contains a greater concentration of THC.[4] As a result, hemp does not produce a “high” when smoked, consumed or otherwise introduced into the body.

CBD is the second commonly known compound in cannabis. Unlike THC, CBD is not intoxicating and can be found in high concentrations in hemp. CBD is often touted as having various medicinal benefits such as reducing anxiety, relieving arthritis pain and aiding in the treatment of seizures. However, until recently all forms of cannabis (including hemp) were illegal at the federal level, and as a result there have been few medical trials about the medical efficacy of CBD.[5]

#### *What is the Law Concerning Cannabis, Marijuana and Hemp?*

As discussed at greater length in previous advisories,[6] the law relating to cannabis can be confusing as it involves an interplay between federal prohibition on marijuana (but not hemp), and various, often conflicting, state laws and regulations that apply to each of marijuana, hemp, THC and CBD.

Starting at the top, federal law under the Controlled Substances Act (the “CSA”) classifies marijuana as a Schedule I drug and prohibits its manufacture, importation, possession, use, and distribution. In other words, marijuana is illegal under federal law. The Agricultural Improvement Act of 2018, commonly referred to as the 2018 Farm Bill, distinguishes hemp from marijuana and removes hemp from the controlled substances

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list under the CSA.[7] Marijuana remains listed as a Schedule I drug under the CSA (i.e., illegal under federal law). By extension, substances derived from marijuana are illegal under federal law, whereas substances derived from hemp are not. Because hemp contains very low concentrations of THC (less than 0.3%) and a high concentration of CBD, federal law effectively permits the production of products containing high concentrations of CBD and a relatively small amounts of THC.[8] The effects of the 2018 Farm Bill is evidenced by the large number of CBD-products now available in stores throughout the country

On the state level, 33 states and the District of Columbia have legalized medical marijuana, and 10 states and the District of Columbia have legalized recreational, or adult-use marijuana. In those states where marijuana has been legalized, for medical use or otherwise, the marijuana industry operates in a gray area, remaining illegal under federal law, but legal under state law.

Looking for a degree of comfort, companies operating in the state-legal marijuana industry have historically relied on statements from the U.S. Department of Justice ("DOJ") as to its enforcement priorities. The most concrete example was the 2013 memorandum from then Deputy Attorney General James Cole (commonly referred to as the Cole Memo). The Cole Memo, while not binding on federal prosecutors, instructed them to direct their limited resources towards a set of enforcement priorities which effectively excluded prosecution of those operating in a professional manner and in compliance with their state marijuana laws. The enforcement priorities in the Cole Memo were roughly in line with the priorities outlined in the DOJ's U.S. Attorney's Manual. Though the Cole Memo was rescinded in 2018 by then Attorney General Jeff Sessions, federal prosecutors retain the ability to prioritize their enforcement activities.

A degree of additional security for the state-legal medical (but not recreational) marijuana industry is found in the "Joyce Amendment" to the 2019 fiscal year budget. The amendment, more commonly known as the Rohrabacher Amendment, after its previous sponsor, prevents federal prosecutors from using federal funds to prosecute state-legal medical marijuana activities. William Barr, Mr. Sessions's successor as Attorney General, has expressed his dissatisfaction with the current inconsistencies between U.S. federal and state cannabis laws. Mr. Barr has also voiced a preference for a uniform federal rule against cannabis, but noted that an approach permitting states to make their own decisions without violating U.S. federal law is preferable to the current framework.[9]

#### *Layering In Regulation – The FDA on CBD & THC*

While the 2018 Farm Bill legalized hemp on the federal level, the bill also preserved the U.S. Food and Drug Administration's (the "FDA") regulation of cannabis-derived compounds, including compounds containing CBD and THC.[10] The FDA has stated that it "treats products containing cannabis or cannabis-derived compounds as it does any other FDA-regulated products — meaning they are subject to the same authorities and requirements as FDA-regulated products containing any other substance." [11] Accordingly, the FDA has deemed both THC and CBD to be active drug ingredients, meaning that "it is a prohibited act to introduce or deliver for introduction into interstate commerce any food (including any animal food or feed) to which THC or CBD has been added." [12] The FDA and the Federal Trade Commission ("FTC") have also expressed concern about some of the claims made regarding the medical benefits of CBD.[13]

Many companies have disregarded the FDA's guidance and continue to produce consumable products containing CBD, often touting unsubstantiated medical claims. While these companies are subject to enforcement actions by the FDA, to date the FDA has limited its actions to sending warning letters to "companies illegally selling CBD products that claimed to prevent, diagnose, treat, or cure serious diseases, such as cancer." [14] Though FDA enforcement appears to be focused on CBD products that make unsubstantiated health-related claims, all food and drug products not approved by the FDA and containing CBD remain prohibited by the FDA.

Non-food and drug-related uses for hemp, as well as THC and CBD derived from hemp, are generally unaffected by FDA regulations. For example, cosmetic products are mostly not regulated by the FDA. Accordingly, not all uses of THC and CBD derived from recently federally legal hemp are susceptible to federal regulatory issues.



## II – Investing In Cannabis

### *How do Investors Invest in Cannabis?*

Despite the legal and regulatory risks associated with cannabis, it is becoming an increasingly popular investment opportunity. Not all cannabis-related investments share the same legal and regulatory risk profile. For example, an investment in a company producing cosmetic products containing hemp, in a state that has adopted a plan in accordance with the 2018 Farm Bill, will come with relatively little legal and regulatory risk if the company is diligent in complying with applicable federal, state and local licensing and regulatory requirements (including assuring its products contain virtually no THC). The hemp used by that company is legal under the 2018 Farm Bill, and cosmetic products are generally not subject to FDA regulation. Conversely, investment in a company growing and selling recreational marijuana and food products containing THC is subject to potential federal criminal charges under the CSA, as well as sanctions from the FDA. With the growth of the cannabis industry, investments are becoming more accessible and opportunities are arising in various forms. Below are a few popular forms of those investments including investments in public companies, exchange traded funds and private placements.

### *Investments in Domestic and Foreign Public Companies*

National U.S. exchanges such as the NYSE and NASDAQ do not permit the listing of companies operating in violation of federal law. Accordingly, as general rule, public companies easily accessible on national exchanges do not operate in the marijuana space within the United States, or operate in a gray area, not “touching the leaf,” but part of the U.S. marijuana industry in tangential, and increasingly transparent roles.<sup>[15]</sup> For example, Innovative Industrial Properties Inc. (NYSE: IIPR), a REIT, focuses “on the acquisition, ownership and management of specialized industrial properties leased to experienced, state-licensed operators for their regulated state-licensed cannabis facilities.”<sup>[16]</sup> Publicly traded tobacco companies are also testing the boundaries of national exchanges with products and brands in or near to the cannabis industry. Turning Point Brands Inc. (NYSE: TPB), a tobacco company, owns Zig-Zag, a brand of rolling paper synonymous with marijuana in pop culture. More clearly illustrating Turning Point Brand’s foray into, or right up to, the cannabis industry, is its 2018 purchase of a 19.99% interest in Canadian American Standard Hemp (“CASH”), a company headquartered in Rhode Island that manufactures CBD. The investment in CASH was followed by Turning Point Brand’s formation of Nu-X Ventures in 2019 which is working collaboratively with CASH to “bring proprietary CBD products to market.”<sup>[17]</sup>

Perhaps closest to a true publicly traded “U.S. cannabis company” is Greenlane Holdings, Inc. (NASDAQ: GNLN). Greenlane, a Delaware corporation with principal offices in Florida, conducted its IPO in April 2019 and offers “premium products to market in the burgeoning head shop, smoke shop, dispensary channels and beyond.”<sup>[18]</sup> Though Greenlane does not touch the leaf, it represents a new level of transparency from a U.S. public company regarding its participation in the marijuana business.

Canadian companies listed on U.S. national exchanges and operating in the cannabis industry outside the United States present another channel to cannabis investing. Several Canadian companies, including Canopy Growth Corporation (NYSE: CGC), Tilray Inc. (NASDAQ: TLRY) and Aurora Cannabis Inc. (NYSE: ACB), all maintain market caps well in excess of one billion dollars.

Both U.S. public companies that do not touch the leaf and Canadian companies that do not operate in violation of U.S. federal law represent relatively conservative investments compared to companies directly involved in the production or sale of marijuana in the United States. These companies can be viewed as striking a balance between risk and reward – poising for expansion if marijuana becomes legalized under U.S. federal law, but avoiding to a degree potential repercussions from violating federal law until such time.

It is important to note, however, that a particularly aggressive interpretation of U.S. federal laws could deem such investments as “aiding and abetting” a criminal enterprise, so the investments are not risk free. For investments closer to the leaf in the United States, an investor must look to private placements, which are discussed below.

#### *Investments in ETFs*

An exchange traded fund, or ETF, is an investment fund that is traded on a public exchange. ETFs allow investors to easily diversify their investment throughout an industry. With the emergence of cannabis stocks on U.S. national exchanges such as the NYSE and NASDAQ, several cannabis ETFs are available. Investments in cannabis ETFs provides some of the protection associated with diversification. In addition, actively managed ETFs leverage the knowledge of investment professionals with an understanding of the cannabis industry.

Not all cannabis ETFs share the same goals or risk profiles. For example, Horizons Marijuana Life Sciences Index ETF (OTC: HMLSF) (TSE: HMMJ) provides “diversified exposure to large publicly-listed life sciences companies with significant business activities in the marijuana industry.” Conversely, Horizons Emerging Marijuana Growers Index ETF (OTCPK: HZEMF) (NEO: HMJR) invests in publicly listed small-cap companies primarily involved in the cultivation, production and/or distribution of marijuana.[20] With the variety of ETFs available, they may be used not only to enter the cannabis industry, but also direct investments towards areas within the industry.

#### *Investments in Private Placements*

Private companies operate without the limitations of U.S. national exchanges and public company disclosure requirements. As a result, private companies are able to operate directly in the federally-illegal marijuana business within the United States. These companies remain susceptible to action by the federal government, as discussed above. As the cannabis industry expands both in the United States and Canada, companies are increasingly looking to private investments to fund operations as traditional sources of capital, including banks and the public markets, are often not available due to the unlawful nature of the businesses.

Investing in private placements of cannabis companies comes with unique risks. Without disclosure requirements, private companies may leave investors without desirable information relating to the operation and health of the business. Moreover, the potential profits that come from the private companies’ ability to produce and sell marijuana in the United States, including in states where such activities are legal, bring the increased risks of operating in clear violation of federal laws.

Unrelated to cannabis, private placements carry additional inherent risks. Investments in private placements often have limited liquidity, require reliance on forward-looking statements, are subject to significant dilution and present tax risks unique to each investor. Private placements are also generally only available to accredited investors.

#### **Conclusion**

With the legalization of hemp at the federal level, and continued legalization of marijuana on a state-by-state level, more investors are beginning to dip their toes into the industry. As the industry matures, more investment opportunities tailored to specific risk tolerances become available. However, as discussed above, risks remain, most notably that marijuana remains federally illegal. Equipped with an understanding of the federal and state, legal and regulatory frameworks surrounding cannabis, investors can better assess the risk of a potential investment.

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[1] See [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia\\_marijuana](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_marijuana); and <http://www.finra.org/investors/alerts/updated-marijuana-stock-scams>.

[2] See <https://www.fool.com/investing/2019/03/03/how-big-could-the-marijuana-industry-grow.aspx>; and <https://www.bnnbloomberg.ca/global-cannabis-market-could-be-worth-up-to-us-130b-by-2029-jefferies-1.1219522>.

[3] See <https://www.fda.gov/news-events/public-health-focus/fda-regulation-cannabis-and-cannabis-derived-products-questions-and-answers#whatare>.

[4] Marijuana typically contains a THC concentration of over 20%, though for purposes of legal analysis, 0.3% distinguishes hemp from other forms of cannabis prohibited under the CSA.

[5] To date, the only FDA approved drug product containing CBD is Epidolex, for the treatment of seizures associated with Lennox-Gastaut syndrome or Dravet syndrome.

[6] See "Things to Consider If You Decide to Invest in the Hemp and CBD Industries," *Client Advisory* (April 18, 2019) available at <https://www.clm.com/publication.cfm?ID=5651&Att=172>; "Protecting Cannabis and Hemp-Related Intellectual Property," *Client Advisory* (May 9, 2019) available at <https://www.clm.com/publication.cfm?ID=5654>; "New Jersey's Coming Expansion of Its Medical Cannabis Regime Presents Opportunities to Sophisticated Operators," *Client Advisory* (May 24, 2019) available at <https://www.clm.com/publication.cfm?ID=5655>.

[7] The Farm Bill Defines Hemp as the plant *Cannabis sativa* L. and any part of that plant, including the seeds thereof and all derivatives, extracts, cannabinoids, isomers, acids, salts, and salts of isomers, whether growing or not, with a delta-9 tetrahydrocannabinol concentration of not more than 0.3 percent on a dry weight basis. <https://www.agriculture.senate.gov/imo/media/doc/Agriculture%20Improvement%20Act%20of%202018.pdf>.

[8] Though trace amounts of THC contained in hemp may be found in federally legal hemp derived substances.

[9] <https://www.newsweek.com/attorney-general-barr-marijuana-law-1392561>.

[10] See "Things to Consider If You Decide to Invest in the Hemp and CBD Industries," *Client Advisory* (April 18, 2019) available at <https://www.clm.com/publication.cfm?ID=5651&Att=172>.

[11] <https://www.fda.gov/news-events/public-health-focus/fda-regulation-cannabis-and-cannabis-derived-products-questions-and-answers#farmbill>.

[12] <https://www.fda.gov/news-events/public-health-focus/fda-regulation-cannabis-and-cannabis-derived-products-questions-and-answers#farmbill>.

[13] See "FTC Joins FDA in Sending Warning Letters to Companies Advertising and Selling Products Containing Cannabidiol (CBD) Claiming to Treat Alzheimer's, Cancer, and Other Diseases," FTC Press Release (April 2, 2019) <https://www.ftc.gov/news-events/press-releases/2019/04/ftc-joins-fda-sending-warning-letters-companies-advertising>.

[14] <https://www.fda.gov/news-events/public-health-focus/fda-regulation-cannabis-and-cannabis-derived-products-questions-and-answers#farmbill>.

[15] [https://www.law360.com/articles/1153142?utm\\_source=ios-shared&utm\\_medium=ios&utm\\_campaign=ios-shared](https://www.law360.com/articles/1153142?utm_source=ios-shared&utm_medium=ios&utm_campaign=ios-shared).

[16] [https://www.sec.gov/Archives/edgar/data/1677576/000114420419013981/tv515308\\_10k.htm](https://www.sec.gov/Archives/edgar/data/1677576/000114420419013981/tv515308_10k.htm).

[17] [https://www.sec.gov/Archives/edgar/data/1290677/000114036119004508/h10061332x1\\_10k.htm](https://www.sec.gov/Archives/edgar/data/1290677/000114036119004508/h10061332x1_10k.htm).

[18] <https://gnln.com/>.

[19] <https://www.horizonsetfs.com/Marijuana-ETFs>.

[20] <https://www.horizonsetfs.com/Marijuana-ETFs>.

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