

# Client Alert

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## USDA Issues Interim Final Rule on Hemp Production

The United States Department of Agriculture (USDA) has issued interim final regulations for the production of hemp under the Agriculture Improvement Act of 2018 (the 2018 Farm Bill). The 2018 Farm Bill requires the USDA to promulgate regulations and guidelines to establish and administer the program for the production of hemp. This rule outlines provisions for the USDA to approve plans submitted by states and Indian tribes for the domestic production of hemp. Hemp fibers can be used in a number of products and the global market for hemp consists of more than 25,000 products in nine submarkets: agriculture, textiles, recycling, automotive, furniture, food and beverages, paper, construction materials and personal care (including CBD oil). The 2018 Farm Bill also allows for the transportation and shipment of hemp within the United States without any interference from local governments.

Under the regulations, a state or tribal nation that wants primary regulatory authority over the production of hemp in that state or tribal territory may submit a proposal for the approval of the secretary of the USDA. If a state or tribal nation does not submit a plan, USDA would administer the programs in those states or territories. Final regulations are expected to be adopted by 2021.

The regulations may encourage financial institutions to provide banking services to companies engaged in the various aspects of hemp production without the fear of violating federal or state laws or criticism by their banking regulator. It is important that a financial institution conduct sufficient due diligence to assure the institution that the product qualifies as hemp under the regulation. If hemp exceeds the specified THC levels noted below, it will be considered marijuana and be subject to confiscation and destruction. Although the federal bank regulatory agencies issued cursory guidance on providing financial services to customers in the hemp industry, the guidance does not lessen BSA obligations if a hemp customer becomes engaged in marijuana, even inadvertently. The policies and procedures that financial institutions should implement would be similar to those in place if they are already serving the cannabis industry.

### History

Prior to the passage of the 2018 Farm Bill, *Cannabis sativa* L. with a delta-9 tetrahydrocannabinol (THC) level greater than 0.3 percent fell within the definition of "marijuana" under the federal Controlled Substances Act (CSA) and therefore was a Schedule I controlled substance unless otherwise excepted. THC is the psychoactive compound providing the "high" in marijuana. The Agricultural Act of 2014 (the 2014 Farm Bill) defined hemp as the plant *Cannabis sativa* L. and any part thereof with a THC concentration of no greater than 0.3 percent on a dry weight basis. The 2014 Farm Bill authorized institutions of higher learning and state departments of agriculture to allow for cultivation of hemp as part of a pilot program, if authorized by state law for research, which led to hemp's being cultivated and sold as an ingredient in various consumer products.

### Regulation

Under the USDA interim final regulations, there are a number of requirements that a hemp producer must meet in order to produce hemp. These include: (1) obtaining a license; (2) maintaining information on the land used for hemp production; (3) procedures for testing the THC concentration levels for hemp; and (4) procedures for disposing of noncompliant plants and for handling violations.

The 2018 Farm Bill preserves the authority of states and Indian tribes to enact and enforce laws regulating the production of hemp that are more stringent than federal law. Thus, while a state or an Indian tribe cannot block the shipment of hemp through that state or tribal territory, it may continue to enforce state or tribal laws prohibiting the growing of hemp in that state or tribal territory.

## **Sampling and Testing**

All hemp production must be sampled and tested for THC concentration levels. Samples must be collected by a USDA-approved sampling agent or law enforcement agency authorized by the USDA to collect samples. The licensed producer must absorb the cost of the sampling and the samples must be tested in a DEA-registered laboratory. The sample must be taken within 15 days prior to harvesting the plants. The sampling method must produce a confidence level that no more than 1 percent of the plant would exceed the acceptable THC level. If the sample exceeds the acceptable level it is conclusive that all the hemp in a particular plot of land is not in compliance and cannot be further handled or processed. The USDA will issue sampling procedures to ensure a representative sample is produced for testing. The “acceptable hemp THC level” will be in a range of uncertainty above and below the 0.3 percent level as determined by the testing laboratory. As long as the test results are within that range, the hemp will be in the acceptable level. If it exceeds the high end of the range (over the 0.3 percent THC level), the product will be considered marijuana and must be properly destroyed.

## **Hemp Producer License**

To cultivate hemp, producers must obtain a license from the state or the USDA if the state has not submitted a plan to the USDA and hemp is legal in that state. The USDA will begin accepting applications 30 days after the effective date of the rule, which was October 31, 2019. The USDA is delaying acceptance of applications for 30 days to give states and tribal nations time to submit their plans first. Aside from the first year of the licensing program, in which applications can be submitted at any time, license applications may be submitted between August 1 and October 31 of each year. Licenses are nontransferrable and must be renewed every three years.

The USDA will conduct random audits of licensees to ensure hemp is being produced in accordance with the regulations. Audits may include on-site visits as well as “desk audits.” Audits will be conducted generally no more than every three years. Licensees that are found to have a negligent violation of the rules will be subject to a corrective action plan. A negligent violation includes (1) a failure to provide a legal description of the land upon which the hemp is being produced, (2) not obtaining a license before engaging in production or (3) producing plants that exceed the acceptable THC level. The USDA will not consider hemp producers as committing a negligent violation if they produce plants exceeding the acceptable THC level if they used reasonable efforts to grow hemp and the plant does not have a THC concentration of more than 0.5 percent on a dry weight basis.

A producer who has negligently violated the rule three times in a five-year period is ineligible to produce hemp for five years from the date of the third violation. Negligent violations are not subject to criminal enforcement but the USDA will report to the attorney general the production of hemp without a license issued by the USDA.

## **Due Diligence**

Institutions need to maintain appropriate due diligence procedures for hemp-related accounts and to comply with BSA and AML requirements to file Suspicious Activity Reports (SARs) for any activity that appears to involve potential money laundering or illegal or suspicious activity. Institutions need to remain alert to any indication an account owner is involved in illicit activity or engaging in an activity that is unusual for the business.

Bank regulators have confirmed through recently issued guidance on banking hemp-related business customers that banks are not required to file SARs *solely* because a customer is engaged in the growth or cultivation of hemp. However, the guidance further provides that banks are expected to follow procedures and file a SAR if there are indicia of suspicious activity. This means banks will be required to gather diligence and monitor hemp-related business customers in order to confirm that customers are complying with the 2018 Farm Bill, state law and any activity limits set by the bank.

Serving hemp-related businesses includes both deposit activities and lending activities. Lending activities must comply with applicable regulations and be conducted in a safe and sound manner. Financial institutions should not lose track of the fact that borrowers that are heavily dependent on products subject to state and federal law could be negatively affected by future regulations, particularly those requiring them to destroy product exceeding federal and state THC levels.

## State Law

Before commencing any banking relationship with a hemp-related business, an institution must first become familiar with any other state and federal laws that prohibit, restrict or otherwise govern these businesses and their activity. As noted above, a state may impose stricter requirements than those contained in the USDA regulations. For example, certain hemp-related products may now or in the future be subject to state health departments as well as the US Food and Drug Administration. This would include CBD products.

## Risk Protection

To mitigate risks with respect to serving hemp-related businesses, a financial institution should implement an effective Compliance Management System (CMS) in which the institution “onboards” the customer consistent with its procedures for higher-risk members and which includes:

- Performing initial diligence on the legality of the activities, including state or federal licensing;
- Ongoing monitoring of hemp customers;
- Developing specific risk tolerances for both credit- and deposit-related hemp customers; and
- Obtaining contractual covenants and obligations from hemp customers.

Institutions entering into this space should build out a CMS with hemp-specific policies and procedures designed to ensure that the hemp business customers are operating within the institution’s established risk parameters and operating under applicable law and their license. The recent federal bank regulatory guidance specifically calls out bank compliance with customer identification, SAR and CTR reporting and risk-based customer diligence.

Institutions should also develop policies and procedures to comply with guidance from the Financial Crimes Enforcement Network (FinCEN) if the hemp’s THC content exceeds legal thresholds or if the customer is determined not to be operating in compliance with federal or state law, in which case the institution may need to implement measures with respect to that customer, including potentially the filing of a SAR. The key to enforcing the institution’s CMS with respect to a particular hemp customer is through contract. Institutions banking hemp need to address legal and compliance requirements through a supplemental agreement with those customers.

In making a decision to bank hemp-related businesses, financial institutions should consider, among other things:

- Does the customer have all licenses and sufficient controls to monitor its legal compliance, including compliance with federal and state law regulations regarding destruction of the product if the THC content exceeds 0.3 percent?

- Will the product, or funds from the product, cross state lines? If so, is the product or activity legal in the surrounding states? Have the customer's hemp industry counterparties obtained all necessary licenses?
- Does the institution have sufficient collateral if lending to hemp-related businesses, given that the product may have to be destroyed or be subject to forfeiture and seizure (along with other assets of the borrower) if the THC content exceeds 0.3 percent?
- Will the institution be processing payments for hemp customers, potentially implicating card network rules?
- Does the institution have flexibility to alter its arrangements with a customer as federal and state regulations are issued with respect to hemp?
- Did the institution obtain board of director approval of hemp banking activity generally and develop board reporting specific to hemp consistent with its existing MIS?

Serving hemp-related businesses provides additional lending and banking opportunities for financial institutions that carries more risk, but on the other hand greater potential revenue, than typical banking relationships. Navigating the hemp landscape can be accomplished through effective risk management. We have advised financial institutions on implementing CMS for higher-risk customers. Doing so, however, will require adjustments and tailoring within financial institution's CMS and agreements with customers prior to commencing the activity to effectively manage the risk. Please do not hesitate to contact Richard Garabedian at 202-419-2117 or Heather Archer Eastep at 202-955-1954 for further information.

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