Significant Legislative Rule Analysis

WAC 314-55-035
Rules Concerning Qualification for a Marijuana License

June 24, 2020

SECTON 1:

Describe the proposed rule, including a brief history of the issue, and explain why the proposed rule is needed.

Existing WAC 314-55-035, describing qualifying for a marijuana license was established in late 2013, and last updated in March of 2016. Current rule provides that all Washington state marijuana licenses must be issued in the name or names of the true party or parties of interest. A true party of interest is currently described as a person who owns, participates in the management of, or otherwise receives a percentage of the profits of a marijuana business in exchange for a monetary loan or in exchange for their expertise in the marijuana business. True parties of interest are held responsible for the conduct of the business, and must undergo a financial investigation, criminal and civil background investigation, interviews, fingerprinting, and other requirements to successfully meet vetting requirements and become eligible for licensing.

True party of interest rules are designed to preclude the establishment of vertical integration, and the potential for criminal enterprise consistent with RCW 69.50.562(2)(b)(iii). Current rule provides that through the application and vetting process, LCB assures that funds entering the Washington State regulated market are not related to or derived from criminal enterprise, and are not vertically integrated among processors and producers. This is designed to discourage monopolies and organized crime.

In August 2018, LCB filed a robust CR102 consisting of omnibus rule changes to implement 2017 legislation. Revisions to WAC 314-55-035 were included in the proposal. At the public hearing on October 3, 2018, multiple stakeholders offered feedback, requesting additional, significant revisions to WAC 314-55-035. When the final rule package was presented to the Board in November, 2018, staff excluded WAC 314-55-035 from the adopted rules to allow for additional development and stakeholder engagement.

In January of 2019, House Bill (HB) 1794 was introduced that proposed amendments to RCW 69.50.395 concerning agreements between licensed marijuana businesses and other people and businesses, including royalty and licensing agreements relating to the use of intellectual property. Since there was potential for the substance of the bill to influence revisions being considered to WAC 314-55-035, the project was temporarily paused until the end of the legislative session. The bill was approved by the Governor on May 13, 2019, and became effective on July 28, 2019.

The proposed rules are the result of protracted, extensive stakeholder engagement that began in late 2018, was temporarily paused as a result of enacted legislation described above, and then realigned with the purpose and intent of penalty rule redesign project that implemented Senate Bill (SB) 5318.

The proposed rules accomplish the following:

- Modernizes the section title, redesigns and reorganizes the section structure;

- Modernizes language regarding which entities are considered to be true parties of interest;
- Removes the spousal vetting requirement;
- Expands definitions to include, “control,” “financial institution,” “gross profit,” “net profit,” and “revenue;”
- Clarifies and expands upon what persons or entities are not considered to be true party(ies) of interest;
- Describes the circumstances under which licensees must continue to disclose funds that will be invested in a licensed marijuana business;
- Incorporates reference to amendments to RCW 69.50.395 regarding disclosure agreements and intellectual property; and
- Establishes a new subsection to distinguish the requirements for financiers from that of true party(ies) of interest.

SECTION 2:

Is a Significant Analysis required for this rule?

Under RCW 34.05.328(5)(a)(i), the WSLCB is not required to complete a significant analysis for this or any of its rules. However, RCW 34.05.328(5)(a)(ii) also provides that except as provided by applicable statute, significant analysis applies to any rule of any agency, if voluntarily made applicable by the agency.

The WSLCB voluntarily asserts that the proposed amendments to WAC 314-55-035(1), (2), (4), (5) and (7) meet the definition of legislatively significant as described in RCW 34.05.328(5)(c)(iii)(C) because they are rules other than procedural or interpretive rules that adopt new, or make significant amendments to a policy or regulatory program.

Proposed new subsection (3) regarding definitions is exempt because it does not meet the definition of significant rule under RCW 34.05.328(5)(c). Subsection (5) is exempt under RCW 34.05.328(5)(b)(iii) because it adopts and incorporates by reference without material change a Washington state statute.

For these reasons, the WSLCB voluntarily offers this significant analysis.

SECTION 3:

Clearly state in detail the general goals and specific objectives of the statute that the rule implements.

The proposed rules implements chapter 69.50 RCW. This chapters codified Initiative 502 (2013), known as I-502.

The stated objective of I-502 was to “stop treating adult marijuana use as a crime and try a new approach” to achieve three specific goals, one of which was to bring marijuana into a tightly regulated, state-licensed system similar to that for controlling alcohol.

Similarly, HB 1794, codified in RCW 69.50.395 more broadly describes terminology referencing authorized agreements related to licensed marijuana businesses and trademarks, trade secrets, and other intellectual property, as well as the types of agreements covered, and the types of business entities that may be parties to any such agreement. These codified amendments respond to changes in agreements between licensed marijuana businesses with other people and businesses, including royalty and license agreements relating to the use of intellectual property.

The proposed rules implement the goals and objectives of chapter 69.50 RCW by revising and updating true party of interest rules to incorporate necessary statutory revisions and references while responding to the rapid growth and maturation of the regulated marijuana market, as well as changes in business and management structures over time.

SECTION 4:

Explain how the department determined that the rule is needed to achieve these general goals and specific objectives. Analyze alternatives to rulemaking and the consequences of not adopting the rule.

The proposed rules realize and embody the intent I-502 and ESHB 1794 by modernizing existing rules and establishing new standards, where appropriate, regarding qualifying for a marijuana license.

Rules are needed to establish clear guidance and enforceable standards for licensees, and assure consistent agency decision making.

SECTION 5:

Explain how the agency determined that the probable benefits of the rule are greater than the probable costs, taking into account both the qualitative and quantitative benefits and costs and the specific directives of the statute being implemented.

1. WAC 314-55-035 – Qualifying for a marijuana license.

Description of the proposed rule:

Existing rule provides that a marijuana license must be issued in the name or names of the true party or parties of interest.

The proposed rule expands on this initial statement by adding language that the Board may conduct an investigation of any party who exercises control of the applicant's business operations, and that the investigation may include financial and criminal background investigation. The proposed additional language originally appeared in subsection (4) of existing rule, but was relocated to the introductory section since background investigation is more closely related to qualifying for a license, rather control of the business.

Cost/Benefit Analysis:

There are no additional compliance costs or administrative burden related to this amended rule section. The cost of the background investigation is a pre-existing regular and customary part of the marijuana licensure process that has been in place since 2013. This amendment does not create new or impose additional compliance costs.

2. WAC 314-55-035(1) – True parties of interest.

Description of the proposed rule:

Existing rule identifies several true party of interest scenarios, along with examples of persons or entities who would qualify as a true party of interest under those scenarios. This initial framework served to guide the agency and marijuana licensees during the establishment of the I-502 system and for a limited period of time thereafter. However, the market has evolved since that time, and as a result of that evolution, licensees and others found the table to contain section headings, words and phrases that would benefit from clearer definition to better guide decision making.

The proposed rule accomplishes significant revision of this table, including reframing headings from "true parties of interest" and "person to be qualified" to "entity" and "true party of interest" to clearly demonstrate which entities are considered to be true party(ies) of interest. Publicly held corporations were removed from the table since the agency does not allow out of state ownership at this time.

More significantly, however, is the removal of the spousal vetting requirement. After extensive, protracted discussion with stakeholders regarding concerns related to this requirement, the agency determined that when assets of a business are or may be held jointly or as a community, the main focus is on business relationship and ownership interest rather than the "spousal" relationship.

WSLCB reasoned that true party of interest could be identified by business type alone, as provided in the revised table described above, and concentrate on who controls, or has a substantial interest in a license, including the nature of the business relationship, and ownership interest as opposed to whether or not one is a spouse. This will move the agency into a vetting process more reflective of the current landscape of ownership and control variances and arrangements, and aligns it with similarly situated community property states. For these reasons, the spousal vetting requirement was removed from the proposed rules.

Cost/Benefit Analysis:

There are no additional compliance costs or administrative burden attributable to these proposed amendments. The rule proposal is anticipated to reduce compliance cost and administrative burden since the spousal vetting requirement would no longer be necessary. These amendments may benefit current and future licensees who have based, may base, or delay personal decisions on the current spousal vetting requirement.

3. WAC 314-55-035(2) – Married couples.

Description of the proposed rule:

Previous rule required spousal vetting under the premise that any property obtained by either spouse during marriage was considered to be community property. Under that premise, limitations on the number of licenses consistent with WAC 314-55-075(5), WAC 314-55-077(3), and WAC 314-55-079(3) applied to parties considered to be true parties of interest.

However, as noted above, the proposed rule concentrates on the nature of the business relationship and ownership interest as opposed to whether or not one is a spouse. Under that premise, married couples could potentially be considered as true parties of interest after attesting no interest in the license of their spouse, in up to ten retail licenses under WAC 314-55-079(3), six processor licenses under WAC 314-55-077(3) and six producer licenses under WAC 314-55-075(3).

This new section provides that a married couple may not be a true party of interest in more than five retail licenses, more than three producer or more than three processor licenses, consistent with the limitations in current rule.

Cost/Benefit Analysis:

There are no additional compliance costs or administrative burden related to this new rule section. The rule does not impose additional fees, administrative or regulatory burden, but rather clarifies and aligns the number of licenses a married couple may have an ownership interest in, consistent with existing rule.

4. **WAC 314-55-035(4) – Who and what is not considered to be a true party of interest.**

Description of the proposed rule:

Existing subsection (2) describes who is not a true party of interest. The section has been renumbered and updated. Previously, three examples were provided of who is not considered to be a true party of interest, and notably this section mentions that a person or entity contracting with the applicant(s) to sell property, unless the contract holder exercises control over or participates in the management of the licensed business in not considered a true party of interest.

The proposed rule expands, updates, and clarifies this list, removes the reference to control, and offers seven examples of what entities are not considered to be true parties of interest, including but not limited to financial institutions, persons who receive bonuses or commissions based on sales, consultants receiving flat or hourly rate compensation under a written contractual agreement.

The term “control” was relocated to the definition section of the proposal. Previously undefined in this existing rule section, the proposal provides that “control” means the power to independently order, or direct the management, managers, or policies of a licensed business, and is applied in this section.

Cost/Benefit Analysis:

There are no additional compliance costs or administrative burden related to this new rule section. The rule does not impose additional fees, administrative or regulatory burden, but rather clarifies who is not considered to be a true party of interest, and provides the agency the flexibility to consider scenarios beyond what is explicitly provided in rule. Licensees will benefit from clear guidance, and rules that offer the agency agility to respond to business arrangement evolution.

5. **WAC 314-55-035(5) – Notification.**

Description of proposed rule:

Current rule provides that after licensure, a true party of interest, including financiers, must continue to disclose the source of funds for all moneys invested in the licensed business. The WSLCB must approve these funds prior to investing them into the business.

In December 2018, the Board approved Board Interim Policy 06-2018 for several reasons. First, pre-vetting funds can take up to fifty days or sometimes longer, depending on the complexity of the funding and the responsiveness of the applicants. Licensees and their representatives asked the WSLCB to address concerns about the

length of time it takes for them to use their own funds to support their licensed marijuana businesses. In some cases, applicants need immediate access to funds to support their business expenses. While vetting the source of funds remains a high priority to the WSLCB, the agency also recognized that applicants may be allowed to invest their own money in their businesses at the same time the agency is vetting the source of funds.

LCB assures that funds entering the Washington State regulated market are not related to or derived from criminal enterprise, and are not vertically integrated among processors and producers

To assure that funds entering the Washington State regulated are not related to or derived from criminal enterprise, the application was revised in late 2018 to reflect licensee recognition that no funds from these sources could be used to fund or be invested in licensed marijuana businesses.

Consistent with WAC 314-55-050(6), a license may be revoked "if the source of funds identified by the applicant to be used for the acquisition, startup and operation of the business is questionable, unverifiable, or determined by the WSLCB to be gained in a manner which is in violation of law." If these rules are adopted, this Board Interim Policy will be withdrawn.

The proposed rules incorporate this allowance, and further clarifies the circumstances under which licensees must disclose the source of funds invested in a marijuana business.

Cost/Benefit Analysis:

There are no additional compliance costs or administrative burden related to this new rule section. The rule does not impose additional fees, administrative or regulatory burden, but rather clarifies and expands the circumstances under which licensees must disclose the sources of funds to be invested in licensed marijuana businesses. Licensees will benefit from clear guidance, and such guidance supports licensee compliance success.

6. WAC 314-55-035(7) – Financiers.

Description of the proposed rule:

Addressed as subsection (3), current rule provides that the LCB "…will conduct a financial investigation as well as a criminal background of financiers."

Prospective investors in a marijuana business, or financiers, do not need to meet residency requirements. However, even resident financiers cannot share in profits from the business nor are they permitted to exercise control over the operations of the

business. Non-resident financers are limited to receiving only a basic return on investment, as if they have given a personal loan to the company.

Financiers, or investors in marijuana business are not considered true parties of interest as long as they do not share in the profits of the business or exercise control over the business. Financiers are also required to undergo a financial investigation as well as a criminal background investigation for the LCB to permit the party to finance a marijuana company.

The proposed rule substantially expands on existing language, connects the definition of financier with WAC 314-55-010(11), and clarifies the circumstances under which a financier may be considered a true party of interest.

Cost/Benefit Analysis:

There are no additional compliance costs or administrative burden related to this new rule section. The rule does not impose additional fees, administrative or regulatory burden, but rather clarifies and expands clarifies the circumstances under which a financier may be considered a true party of interest. Licensees will benefit from clear guidance, and such guidance supports licensee compliance success.

SECTION 6:

Identify alternative versions of the rule that were considered, and explain how the agency determined that the rule being adopted is the least burdensome alternative for those required to comply with it that will achieve the general goals and specific objectives stated previously.

Rule Development and Stakeholder Engagement Process

As noted above, the proposed rules are the product of a protracted rule development process that began in November of 2018, paused during the 2019 legislative session in response to the introduction of HB 1794, and restarted in July 2019. Initially, the WSLCB had hoped to develop these rules along with the penalty reform rule project implementing HB 5318. Unfortunately, that was not possible given the complexity of this subject, the desire to complete the penalty reform rules, and the multiple perspectives on TPI that emerged during the course of discussion.

The WSLCB's stakeholder engagement process encouraged parties to:

- Identify burdensome areas of existing and proposed rules;
- Propose initial or draft rule changes; and
- Refine those changes.

From August 2019 to February 2020, WSLCB hosted multiple meetings, engaging the same group of industry members and their representatives who worked on the development of the penalty rule redesign that began in March 2019. A Listen and Learn session was scheduled for early March 2020, but this session was postponed based on the Washington State response to the COVID-19 pandemic. A Listen and Learn session was held virtually in May 2020 after messaging was delivered by GovDelivery in early

May. The session was well attended by over sixty participants. Comments received from that session are attached hereto. While these comments are considered informal because they were received before the CR102 was filed, WSLCB offers these here to demonstrate the interest and broad range of perspectives presented during this session.

WSLCB considered these comments, and made a number of revisions to the draft conceptual rules offered at the May 20, 2020 Listen and Learn session based on these comments. The proposed rules are a result of this iterative and inclusive process.

Summarized below is a brief description of the main discussion topic that emerged during the Listen and Learn session related to the proposed rule set, and how the agency collaborated with stakeholders to mitigate potential burden associated with rule compliance:

Issue	Potential Burden	Mitigation Strategy
Definition of “control”	An overly prescriptive definition of may result in a variety of unintended consequences, including but not limited to disproportionate impact on the smallest marijuana businesses, and result in suboptimal outcomes when applied to this specific industry that continues to rapidly evolve. Prescriptive regulations do not support the goals and objectives of chapter 69.50 RCW, and instead impose special interest solutions on all that benefit a limited number of licensees.	The benefit of a rule must justify its burden. Here, after many months of exhaustive discussion with industry members and their representatives, the WSLCB opted for a less prescriptive definition to plainly, and broadly describe “control” in this context. This definition closely aligns with other states, and in alignment with industry members, WSLCB prefers to encourage disclosure rather than imposing prescriptive regulations that limit, rather than encourage, compliance.

SECTION 7:

Determine that the rule does not require those to whom it applies to take an action that violates requirements of another federal or state law.

The rules do not require those to whom it applies to take action that violates requirements of federal or state law.

SECTION 8:

Determine that the rule does not impose more stringent performance requirements on private entities than on public entities unless required to do so by federal or state law.

The rules do not impose more stringent performance requirements on private entities than on public entities.

SECTION 9:

Determine if the rule differs from any federal regulation or statute applicable to the same activity or subject matter and, if so, determine that the difference is justified by an explicit state statute or by substantial evidence that the difference is necessary.

The rules do not differ from any applicable federal regulation or statute.

SECTION 10:

Demonstrate that the rule has been coordinated, to the maximum extent practicable, with other federal, state, and local laws applicable to the same activity or subject matter.

These rules did not require coordination with federal, state, or local laws.