



The Growing Legality of Marijuana in America

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The Vice Fund (Symbol: VICEX) from USA Mutuals has been investing in alcohol, tobacco, defense, and gaming industries since 2002. However, the emergence of a “new” vice industry in cannabis has been, by far, the subject that we receive the most questions about from investors and advisors. This paper is the first of a series in which we hope to address those investor questions and explore the future of marijuana in the United States. Our goal with this series of pieces is to assist you in gaining a basic understanding of the legal, political, economic, and financial landscape of the developing marijuana industry. Along the way, these papers will also outline how USA Mutuals has positioned the Vice Fund to potentially benefit from these trends as the marketplace evolves over the next five to ten years.

Summary

The current legal environment in which some states have legalized marijuana and the federal government maintains prohibition has created a positive feedback loop in which voters will move national policy to legalize cannabis. We believe that this process is inevitable and concludes with large established companies dominating in the marijuana industry.

PART I – HOW WE GOT HERE

Roots of Marijuana Prohibition

Federal and state laws restricting marijuana developed over the 20th century culminating in the Controlled Substances Act in 1970 (CSA). The act made marijuana an illegal Schedule I drug along with other illicit drugs such as Heroin, LSD, and Ecstasy. Congress viewed these drugs to have high potential for abuse and no medically accepted treatments. Cannabis being a Schedule I drug has significantly limited the exploration of medical research into the potential benefits of cannabis in a clinical setting.



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Rise of Medical Marijuana

George H. W. Bush's termination of the Compassionate Investigational New Drug Program in 1992 (See *Ole Miss is in the Weed Business*) arguably led to the rise of the medical cannabis movement at the state level. When the federal government removed any pretense of allowing medical marijuana on even the most limited basis, advocates turned to state governments to change law. In 1996 the first state law legalizing the use of medical marijuana hit the books when California passed the Compassionate Use Act. Slowly, a few cautious states followed suit and by 2005 medical marijuana was legal in nine states.

Gonzales v. Raich

As medical marijuana was legalized in these states, advocates looked for a case that would call into question the ability of the federal government to regulate home grown medical marijuana. They thought they found it in a case involving Angel Raich growing medical marijuana at home. Without getting too deep into the weeds, the Supreme Court ruled in *Gonzales v. Raich* that the federal government's ability to regulate the growth, sale, and use of marijuana is virtually unlimited. Further, the Supremacy Clause of the Constitution pre-empted any medical marijuana law that a state may pass. Marijuana prohibition advocates celebrated the ruling thinking that medical marijuana was a dead and buried issue. They could not have been more wrong.

Since that ruling in 2005, an additional 20 states have approved medical marijuana and eight states have approved recreational use. Laws have come through ballot initiatives as well as normal passage through state legislatures indicating that support in these states is broad and politically feasible. Prohibition advocates were understandably asking themselves "what happened?". Rather than ending the practice, *Gonzales v. Raich* seemed to accelerate and expand marijuana use in the United States. How was this possible?

Anti-Commandeering Doctrine

The Supremacy Clause of the Constitution is fairly well known and states that federal law preempts

Ole Miss is in the Weed Business

Ole Miss has a reputation as a bit of a party school and that reputation may have more merit than you think. The Federal Government has a pot farm at the University of Mississippi. It is the only legally grown pot in the United States as far as the justice department is concerned. The federal government uses its pot farm at Ole Miss to supply cannabis for two primary uses.

First, the Compassionate Investigational New Drug Program, which the Carter Administration started after a series of lawsuits arguing that there was no evidence to support a medical prohibition on pot. The program was supposed to supply medical marijuana for those in need but rarely did so. The program approved a total of 43 patients, and most of that small number never actually received marijuana from the program. George H. W. Bush shut it down in 1992 as part of its desire to get tough on drugs. Today, there remain four patients who are grandfathered into the program and receive 300 freeze dried joints from the federal government each month.

Second, the farm at the University of Mississippi supplies marijuana for research into medical uses of cannabis. These efforts have been extremely limited, which is unlikely to change without any change to the federal view on marijuana.



state law. If the federal government says something is illegal, then it is illegal no matter what states say. Cannabis advocates, however, had a lesser known concept to use in the fight over legalization. The Anti-Commandeering Doctrine says that Congress cannot impose targeted, affirmative, coercive duties on state legislators or officials. More simply, Congress cannot tell state legislatures or state officials to enforce federal laws. For example, Congress can require background checks for gun purchases but it cannot require state officials to run those background checks. It sounds simple enough but there are some important consequences of this concept. In the case of cannabis, Congress can make marijuana illegal, but they cannot require that state legislators to pass laws making marijuana illegal and cannot require local law enforcement to enforce federal laws. As discussed in the “Federal Enforcement” section, below, the federal government does not have the resources or the political will to enforce its marijuana ban.

The result allows a path for marijuana to be illegal while the practically legalized market for it grows at the same time. The core of all medical marijuana programs are state laws that exempt possession, cultivation, and distribution of medical marijuana from state imposed legal sanctions. The state is essentially turning a blind eye to the medical portion of pot market. This position has no impact on federal laws or federal law enforcement through the Drug Enforcement Agency (DEA). In states with legalized recreational use, the state has laws that regulate the possession, distribution, and sale of marijuana. As long as the state is not distributing marijuana, they are not breaking the Controlled Substances Act and there is little that the federal government will do about it under the current regulatory apparatus.

The Cole Memo – Can’t we be friends?

With the approval of recreational marijuana in Colorado and Washington in 2012, the federal government had to decide how to deal with a new kind of marijuana issue. The memo issued by former Attorney General James Cole on August 29, 2013 gave the justice department a list of priorities in its enforcement of marijuana laws. It was modeled on an earlier memo that spelled out how to deal with medical marijuana states. Essentially, it focused the justice department’s enforcement efforts on preventing distribution to minors, sales by criminals, preventing distribution to other states, and preventing public health consequences among other things. This memo gave the state level use of marijuana breathing room to grow with less risk.

Federal Enforcement

The ability of the federal government to apply its laws concerning marijuana is limited by the resources allocated to enforcement. DEA raids of medical marijuana dispensaries and enforcement of federal law were significant during the period after *Gonzales v. Raich* during George W. Bush’s presidency and increased in the first part of Barack Obama’s presidency. Yet states and voters continued to approve medical and recreational marijuana, and the tide began to turn in favor of practical legalization after the Cole Memo (see panel). The Obama justice department decided to use prosecutorial discretion to ignore marijuana use that state laws deemed legal. It is reasonable to assume that the Attorney General simply had bigger issues to deal with than marijuana dispensed in an orderly, regulated fashion or that he did not want to turn the justice department into a full-time marijuana enforcement division.

In 2013, Congress took a much more significant step towards legalization when it passed the Rohrabacher-Farr Amendment. With significant bi-partisan support, the amendment forbids the justice



department from using any funds to interfere with states implementing their own medical cannabis laws. It was no longer an issue of the justice department ignoring medical marijuana, now, Congress had officially ordered US prosecutors not do anything about state authorized medical cannabis. Medical marijuana appeared to be in the process of stabilizing with fairly solid footing. However, this fight is not over. Congress has to renew the amendment each year. Despite fairly strong bi-partisan support to renew the amendment, the legislature has only extended it for short periods of time during 2017. Currently, the amendment may not get out of committee to be extended in 2018. Additionally, the current Attorney General, Jeff Sessions, has pressured members of Congress to give the justice department back the ability to spend money to prosecute medical marijuana. We will watch how these issues develop with great interest as they will have a significant impact on the federal government's ability to enforce its marijuana ban.

PART II – WHAT'S NEXT?

Marijuana's Feedback Loop

Today, many states have legalized marijuana to varying degrees and the federal government does not take action to actively suppress use where an orderly, regulated market is in place. But will it continue? Failure to renew the Rohrabacher-Blumenauer Amendment, as it is now called under current sponsors, would be a step back from the process of legalization. There is no denying that. Our position is that such action would likely be more akin to the last stand of the opposition rather than a true reversal of a trend that we believe leads inevitably to legalization on the federal level. There are three reasons, each a step in a process, that we feel lead inevitably to legalization in some form.

1. It is a given that states have passed and will likely continue to pass laws using the protection of Anti-Commandeering Doctrine to legalize various types of marijuana. With each state passing new laws opening up the marijuana market, more U.S. citizens are consuming cannabis.
2. Strange as it is to say, the Federal Government of the United States of America does not have the resources to effectively enforce the marijuana ban on its own without parallel state enforcement. Let us assume that Congress does not renew the Rohrabacher-Blumenauer Amendment and the justice department decides to pursue marijuana enforcement and prosecution in the U.S.. In 2012, the final year of operation before the Rohrabacher-Farr Amendment, the DEA made 31,628 state and federal arrests of which 6,087 were for marijuana. There are 4,600 DEA special agents today, about the same as 2012. The National Institute of Health estimates that 22.2 million Americans used marijuana in the past month. Using these figures, alone, means users have a 1 in 3,640 chance of being caught by federal action. The risk is too low to deter recreational use, and far too low to deter medical use by patients who view marijuana as a treatment. Unless the DEA was willing to hire substantially more agents and ignore cocaine, heroin, and methamphetamines the average marijuana user is essentially safe. This enforcement situation is exacerbated by the fact that cannabis can grow virtually anywhere (there is a reason cannabis is also called weed). If the



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DEA and justice department were to take action against growers or distributors instead of end users, the likely results are either a reduction in the size of the participants or end users could simply grow their own. Under either scenario, there would likely be limited impact on the total supply of cannabis.

3. As states continue to approve usage and as the justice department can do little to stem the tide, American voters become comfortable with normalized social views of marijuana. The stigmas, fears, and assumptions concerning cannabis consumption for medical or recreational use continue to dissipate. More voters will question the rhetoric calling for prohibition and enforcement against something they view to be more socially acceptable than in the past. The result is that voters become more comfortable with lax enforcement or changes in the law. This process is already apparent as public support for legalizing marijuana has jumped by around 20 points in the past six years to approximately 60% in three recent polls. (Gallup - 60%, CBS - 61%, Quinnipiac - 60%). Support for medical marijuana legalization has been seen in the 80-95% range. Demographic changes also confirm this shift in voter views as support for legalization is stronger under age 70 and opposition for legalization is higher among those over 70.

In the end, changes in voter views lead to additional reform of state laws starting the process over in a positive feedback loop. Furthermore, the changing view of the population leads to a friendlier Congress. Political will to enforce increasingly unpopular laws dissipates. While it may take some time to change the Controlled Substances Act, eventually it will be politically attractive for governments at both the state and federal level to take steps to legalize both medical and recreational marijuana. With legalization, the marijuana industry will gain access to the financial support it desperately seeks right now. Well-funded companies with experience and economies of scale in the manufacture and distribution of similar products, particularly tobacco but also alcohol, will step in to rapidly expand the market. We believe the Vice Fund (VICEX) is ideally positioned to take advantage of this trend as these industries are at the core of its lower volatility, more stable approach to equity investing. We will address which equities we believe will most benefit from legal marijuana in detail in a future paper.

Conclusion

The current trend towards more legalization of marijuana for medical and recreational use has created a positive feedback loop with more voters becoming comfortable with cannabis leading to changing views from the political establishment. We view these trends leading inevitably to changes of the federal statutes concerning marijuana and we believe that the Vice Fund is already positioned in the companies that will likely benefit from this transition. We will address that in more detail in a future paper.

Please be on the lookout for our next installment: The Economics of Marijuana in America

If you would like to know more about how we invest or if you have any questions about the Vice Fund or USA Mutuals, please contact us at **1.800.MUTUALS**, email at FA.sales@usamutuals.com, or visit us at www.usamutuals.com.



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