TO: **Michele N. Nakata, Chair**

Act 169 (2021)[1] Dual Use of Cannabis Task Force

FROM: **Market Structure Group**

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[1] Act 169 (SLH 2021), SECTION 4. (a) The office of medical cannabis control and regulation shall convene a task force to explore the development of a dual system program of the legalization of cannabis and the impacts of legalization of cannabis on qualifying patients, including access to medical cannabis by qualifying patients. (b) The office of medical cannabis control and regulation shall submit a report of its findings and recommendations, including any proposed legislation, to the legislature no later than twenty days prior to the convening of the regular session of 2023.

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Market Structure Group Mission Statement

To identify and make recommendations on the structure of the adult-use cannabis market that could be allowed including 1) types of licenses that could be allowed, 2) restrictions on licenses, and 3) home growing, to create a profitable, sustainable, environmentally friendly and tightly controlled and regulated market that reduces youth access and limits the legacy market.

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Background on the Market Structure Group

The Market Structure Permitted Interaction Group ("Market Group") met on June 22, 28; July 5, 26; and August 2, 9, and 15. The Market Group found that in implementing adult use cannabis programs, other states have endeavored to develop a healthy market ecosystem grounded on balanced supply and demand; an equitable, policy-driven distribution of market share; effective tools to ameliorate the public health impact of increased cannabis consumption; targeted strategies to transition the legacy market to the regulated market; and the application of tax revenue to designated public purposes. The Market Group found that due to a variety of factors, states have had mixed success in achieving these goals, and Hawaii can benefit from the lessons learned in other states to develop Hawaii-specific policies that will better achieve these goals.

Market Group Goals for A Healthy Cannabis Market

In fulfilling its mission, the Market Group identified the following specific goals to implement in the proposed market structure for a dual-use cannabis industry in Hawaii.

1. Create a license structure that will limit the legacy and gray market by offering effective on-ramps into the regulated and licensed adult use program.

2. Determine what should be retained from the existing medical program structure and carried over into the adult use program, especially regarding home grow and cooperatives.

3. Envision an effective licensing structure for an inclusive industry that provides opportunities for local business owners and facilitates innovation and industry growth.

4. Minimize over-saturation and under-provision of cannabis in the market (noting that this cannot be eliminated, and prices are likely to fall substantially as the market develops).

5. Design a financing structure for the regulating authority that will eventually lead to the regulating authority to be self-sufficient and not reliant on government funding (general fund appropriations).

6. Recommend regulations in concert with the above goals that facilitate a profitable, sustainable, environmentally friendly, and regulated market that reduces youth access.

Market Group Summary of Recommendations

What follows is a general summary of our recommendations. The specific recommendations are included in each section of the report as indicated in the Table of Contents.

1. The following restrictions should not be stronger than the laws and restrictions that currently govern alcohol breweries, distilleries, distributors, and retail locations. The goal is to bring the cannabis market into being as a legal market – most of the rules governing the cannabis market do not need to be created *sui generis*. Consumer protection, common law nuisance, county building safety/building codes, AOAO covenants, tax compliance, business registration requirements, labor laws, insurance requirements, etc… already exist and will be applicable to the industry. A successful legal cannabis market will use its regulations to fill in any considerations specific to cannabis *in the current regulatory scheme for agriculture and agriculture product markets*. The market structure should not be designed to create a stand-alone industry that would require a large amount of individual oversight by the regulatory authority and regulatory overlap with current agencies and rules.

2. The licensing structure should be horizontal, with a variety of licenses for all plant-touching elements of the supply chain, and no limits on how many licenses different types of licenses that a licensee may acquire (i.e. voluntary vertical integration).

3. Home grown cannabis plants for personal use by those over the age of 21 should not require a license to grow up to 20 plants.

4. To avoid other state's unique challenges in the oversupply and undersupply of cannabis, the regulatory body should be given authority to manage license fees and other license requirements to manage the general number of cultivation/retail licenses in the market.

5. The State should establish geographic indicators, appellations, or other forms of intellectual property or branding protection, similar to the Department of Agriculture's "Seals of Quality" program and potentially in partnership with the Hawaii Tourism Authority, to protect and promote Hawaii's unique genetics and world-renown brand.

6. Similar to other states, there should be an independent regulatory body that consists of a smaller oversight board supported by a larger advisory board yielding the powers and duties to regulate and control the adult-use and medical cannabis licensing and registration programs.

Market Group Full Report

A. General Market Structure – Vertical vs. Horizontal Market Structure

Recommendation: Given the examples of other states and in accordance with the stated goals for Hawaii included at the beginning and throughout this report, a horizontal licensing structure, with the option for a single licensee to obtain more than one type of license, is the recommended strategy for Hawaii's adult-use market.

Findings: "Vertical Integration" is the requirement that all elements of the production, manufacturing, and sale of cannabis be handled by a single entity, under a single license as in Hawaii's current medical cannabis program. "Horizontal Licensing" provides for a variety of licenses for all cannabis touching businesses involved in the industry.

States vary greatly in their regulation of adult-use cannabis markets. While medical cannabis market structures frequently require vertical integration of market participants, no adult-use market currently requires vertical integration.[2] All adult-use markets use horizontal licensing structures. Some adult-use states allow participants to obtain more than one license to create firm-specific vertical integration or allow vertical integration under a single license.[3] A few adult-use states outright ban vertically integrated businesses.[4] What follows are the benefits of each licensing structure. Each structure's benefits are the detriments of the other system.

1. Benefits of Horizontal Licensing

- **Less expensive for businesses and encourages innovation.** Cannabusinesses considering vertical integration must have or raise significant capital to make it work – processes, people, build-out, equipment, leases, banking, compliance for every level of the organization. It costs 3 to 10 times more to run a single vertically integrated piece than its component parts. This means it is incredibly challenging for small businesses to enter the cannabis industry in states that demand vertical integration. For these smaller operations, it can be overwhelming to handle all the requirements from a financial standpoint. Horizontal licensing provides options for small businesses, makes the transition from the legacy market to the legal market easier, and reduces the cost of innovation.
- **Encourages small businesses.** Banning vertical integration could also favor small businesses and encourage market participation by giving them an opportunity to

[2] Medical Markets that Require Vertical Integration – Hawaii (HRS Ch. 329D), Arizona, Delaware, Florida, Massachusetts, Minnesota, New Hampshire, New Mexico, New York, Virginia.

[3] Allows Vertical Integration on Same License – Montana, North Dakota, Minnesota, Michigan, New Mexico, Oklahoma, Hawaii, West Virginia, Florida, New York, Vermont, New Hampshire, Maine, Rhode Island, Massachusetts, New Jersey, Delaware, Washington DC, Virginia.
Allows Vertical Integration with Multiple Licenses – California, Alaska, Nevada, Arizona, Colorado, Missouri, Illinois, Ohio, Maryland, Connecticut.

[4] Does not Allow Vertical Integration – Washington, Oregon, Utah, Arkansas, Louisiana, Pennsylvania.

participate. Many powerful, rich entrepreneurs would be able to drive out mom and pop shops if allowed to grow and sell in a vertically integrated system.

- **Greater product diversity.** A horizontal structure allows for more market participants, growing a greater diversity of products, and serving more, different needs of customers. Supply will be responsive to consumer demand instead of dictated by the vertically integrated businesses large production runs.
- **All elements of industry are independently licensed and regulated**. Under a horizontal system, each type of cannabis touching business is separately regulated with tailored regulations. This allows for more fine-tuned regulation, enforcement, and opportunity to transition legacy operations to regulated ones. This also allows for the governing authority to better respond to manage aggregate supply and demand issues in the market.
- **Enhanced consumer, medical and adult-use, options.** Because retailers are able to buy from multiple growers, their product lines are diverse and they can have exclusive contracts, creating competition. Additional sources of cannabis allow for more tailored development of unique strains rather than the mass produced, popular strains necessary to support a vertically integrated business model. Without vertical integration, many more shops are able to survive, reducing the customers' distance from a cannabis shop.
- **More licensing fees/taxes.** Under a horizontal system, there is more money to be made from licensing fees, from taxing each step of the supply chain, from encouraging a larger industry, and from decreasing the size of the legacy market – increasing revenue for enforcement.
- **Vertical Integration does not encourage specialization and attendant cost-savings/quality benefits for consumers.** While it is possible to specialize in all vertical sectors, vertical integration makes businesses a "jack of all trades" versus a master of one craft. It is often better to specialize in a single vertical rather than specializing in all of them. Horizontal allows businesses to specialize: Growers create their strains and grow at high volume; processors test and finalize the product for safe consumption; and retailers have the freedom to buy from multiple growers.
- **Vertical integration makes it nearly impossible for equity applicants to succeed in the industry.** Successful cannabis company owners are prominently white, shutting out people of color from entering the industry. A horizontal scheme with lower barriers to entry provide equity market participants an opportunity to effectively succeed in the industry.
- **There is a higher risk of failure of vertically integrated businesses.** Due to the high capital costs, higher regulations, and more potential failure points, vertically integrated businesses are considerably more likely to fail than the national average for failed businesses. Such failures significantly impact the market and cannabis availability as it takes years to successfully apply for and stand up a new vertically integrated licensee to replace the prior business.
- **Vertical integration increases utility usage.** Vertically integrated businesses focus on high production facilities and efficiency at the cost of increased use of electricity, water, sewer services, pesticide, etc… Horizontal licensing spreads out licensed activities over a larger area mitigating the impact on any one area. Horizontal licensing also encourages innovation in outdoor, artisanal growing, and reduces the costs of experimenting with low-cost, outdoor grows.

- **Vertical integration cannot supplant the legacy industry.** In a vertically integrated industry, everything is too expensive/facially regulated to invite in the illegal industry and everything is more expensive.
- **Risk of monopoly/oligopoly in vertical system.** Over-limiting participants could create a de facto monopoly—which could be desirable or undesirable, depending on state goals, the behavior of licensees, and the ability of those licensees to influence future regulation.
- **Vertical integration does not take advantage of market forces/price signals.** Vertical integration/top down control by government does not allow the market to determine winners/losers or find the optimal price for cannabis to compete with the legacy market.

<u>2. Benefits of Vertical Licensing</u>

- **May be easier to oversee.** Rather than a more competitive market with numerous participants; vertical integration may help states manage the industry more efficiently. Fewer market participants mean fewer inspectors and other oversight resources.
- **Benefits to businesses.** The majority of the benefits from vertical integration accrue to the lottery winners of the vertical license rather than to the licensing state, local population, or industry as a whole.
    - **More control of supply chain.** Business owners who vertically integrate have greater control over their whole production process. This can translate to producing products at a cheaper cost.
    - **More reliability.** By bringing cultivation, manufacturing, and retail together, a businesses supply chain becomes more reliable than when these verticals run independently of one another. Retail and processor components are given access to high-quality raw materials and finished products, and the cultivation facet does not have to worry about finding someone to purchase the yields.
    - **Greater economies of scale.** Since vertical integration can lower overhead costs and increase profitability, a business can drastically improve your economies of scale.
    - **Faster Product Changes.** Vertical integration allows for faster changes to product offerings. For instance, if one strain is flying off the shelves, the retail team can let the cultivator team know, who can adjust the supply accordingly.
    - **Attractive to big investors.** For business operators interested in an M&A for their cannabusiness, significant investors find vertical integration appealing. These are the investors who are looking for plug and play models with proven track records. Vertically integrated cannabis businesses are usually acquired at a premium because it is challenging to build a cannabis supply chain, integrate teams, implement systems, and handle other aspects of creating these operations.

B. Licensing

<u>Recommendation</u>: Any comprehensive licensing scheme for a successful cannabis industry must include licenses for the following cannabis-touching activities:

- Cultivation (commercial and individual)
- Manufacturing/Processing
- Distribution
- Delivery

- Testing
- Transportation
- Retail
- On-Site Consumption

These licenses should be "stackable", i.e., so long as the requirements for a particular license type are met, there should be no limit on how many different types of licenses that a licensee might acquire. There should be a numerical limit on how many licenses of a particular type that a licensee might acquire to prevent monopolization of the market.

Findings: A successful cannabis industry requires a deregulated industry and regulated businesses. As discussed elsewhere, this can be accomplished through a horizontal licensing system, which would be applicable to both adult use and medical cannabis licensees.

1. Proposed Licensing Scheme

To give the regulating authority flexibility to manage the industry and to provide the greatest opportunity for regulated participation in the industry, the licensing system should be set up in a manner that will allow for approval if the applicant meets the requirements for licensure. This contrasts with a system where each license is distributed by auction or lottery under a certain cap on licenses within a particular license type.

The Market Group recognizes that a significant consideration in establishing a successful licensing program relates to oversaturation or under provision of cannabis and that Hawaii and other jurisdictions have limited the number of available licenses as a means of controlling supply and demand. However, by shifting to the horizontal licensing model and diversifying the licensee population, the setting of license caps at the start of the program may be premature. To ensure that oversupply or undersupply can be timely addressed, the regulatory authority should have broad authority to make adjustments to licensing criteria and license pricing, provided adequate notice is provided to stakeholders and provided the adjustments are data-driven.

a. Cultivation Licensing

Recommendation: Accomplishing the following goals will require a flexible licensing structure with different levels of cost and regulation for different sized grow operations. To the extent that cannabis is legalized in Hawaii, the following restrictions should not be stronger than the laws and restrictions that currently govern alcohol breweries, distilleries, distributors, and retail locations. Our proposal is to put the provision of cannabis licenses on a sliding cannabis license fee scale.

Findings: Regulation of cultivation licenses varies dramatically across the United States. Hawaii in particular needs a system that simultaneously addresses several concerns. The system for cultivation licenses needs to: (1) provide for the continuation of small individual grows; (2) allow for the easy transition of the legacy market into the new, legitimate licensee structure; (3) encourage small, artisanal farmers across the islands to take advantage of Hawaii's unique micro-climates and cannabis genetics; (4) create sufficient supply for both the local and tourism markets; (5) prioritize local ownership of cannabis businesses; (5) forestall the domination of the industry by large, multi-state operations; (6) continue to protect the safety of industry participants and consumers alike; and (7) and prepare Hawaii to compete as an exporter on the national and international stage over the next ten to twenty years.

Limited, lawful homegrow is an important element of any legalized cannabis regime. Per the cannabis regulators panel in the May 31, 2022 meeting of the dual use cannabis task force and the Market Group's research, homegrow varies across legalized states between 4 and 20 adult plants. Due to Hawaii's extensive history with medical cannabis and adult-use homegrow, the unique knowledge amongst Hawaii residents about growing cannabis, and the affordability of homegrown cannabis for medical patients on fixed incomes, the Market Group finds that a larger number of homegrow plants is important for the benefit of Hawaii's medical patients and residents. Specifically, the Market Group recommends between 12 and 20 homegrow plants and that "plant" for the purposes of homegrow should match the definition of a "plant" currently applied to the Medical Dispensaries under the Hawaii Revised Statutes and administrative rules.

Following is the Market Group's proposed licensing structure:

(i) All Cultivation Licenses

- Can sell seeds/clones to other cultivation licensees and retail licensees
- Sell cannabis directly to retail licensees or consign their cannabis through retail licensees
- Must test cannabis to meet state health standards prior to any sale to consumers
- Submit an audit along with every license renewal (the scope of the audit will vary by licensee size)
- Grow outdoors and/or indoors in accordance with other health, agricultural, or state/county building/zoning codes
- Commercial cultivation licensees can only sell to other licensed cannabis businesses

What follows are proposed applications of these requirements to the various levels of licenses. The square footage requirements apply to the cumulative indoor and/or outdoor footprint for the cultivation, storage, and any other location of cannabis on a single property. Cannabis cultivation locations on different properties require separate licenses for each location.

(ii) Home Grow – No license required

- Limited to twenty (20) plants
- Definition of "plant" should match the current definition as applied to current medical dispensaries under the Hawaii Revised Statutes and administrative rules.
- Default right of all adults over 21 years of age under decriminalization/de-scheduling/legalization
- Any individual can gift, barter, or trade cannabis grown personally if they can prove the transaction was noncommercial in nature

- Any individual can sell their individually grown cannabis to any licensed participant in the cannabis industry.
- Any individual can sell their individual grown cannabis directly to consumers if they obtain a cultivation license and test/label the product in accordance with state regulations
- All individuals growing plans are subject to random inspections by the regulating authority to ensure compliance (chiefly in response to third-party reports)
- No testing requirements unless the individual intends to sell the product
- Must comply with all rules and regulations governing the grow site including covenants, AOAO rules, and state and county rules and regulations

(iii) Commercial Grow – 20+ plants up to 499 square feet under cultivation

- A cultivation license is required. Approval of a cultivation license requires:
    - Proposal of square footage to be covered by the license
    - Location of the cultivation
    - Self-Certification of compliance with all local/state/county rules and regulations
    - Payment of scaled licensing fee
- Renewal of a cultivation license requires the licensee to:
    - Report the square footage covered by the license
    - Report the location of the cultivation
    - Recertify compliance with local/state/county rules and compliant security plan
    - Submit evidence of business operation and tax data
- Subject to random audits/inspections by the regulatory authority
- Grow must be permanent/non-mobile

(iv) Commercial Grow – 500 to 999 square feet under cultivation

- A cultivation license is required. Approval of a cultivation license requires:
    - Proposal of square footage to be covered by the license
    - Location of the cultivation
    - Approved plan for compliance with all local/state/county rules and regulations
    - Payment of scaled licensing fee
- Renewal of a cultivation license requires the licensee to:
    - Report the square footage covered by the license
    - Report the location of the cultivation
    - Provide evidence of compliance with local/state/county rules and compliant security plan
    - Pay the scaled licensing fee
    - Submit evidence of business operation and tax data
- Subject to random audits/inspections by the regulatory authority
- Grow must be permanent/non-mobile

(v) Commercial Grow – 1,000 to 4,999 square feet under cultivation

- A cultivation license is required. Approval of a cultivation license requires:
  - Proposal of square footage to be covered by the license
  - Location of the cultivation
  - Approved plan for compliance with all local/state/county rules and regulations
  - Payment of scaled licensing fee
- Renewal of a cultivation license requires the licensee to:
  - Report the square footage covered by the license
  - Report the location of the cultivation
  - Provide evidence of compliance with local/state/county rules and compliant security plan
  - Pay the scaled licensing fee
  - Submit evidence of business operation and tax data
- Subject to random inspections by the regulatory authority
- Grow must be permanent/non-mobile

(vi) Commercial Grow – 5,000 to 9,999 square feet under cultivation

- A cultivation license is required. Approval of a cultivation license requires:
  - Proposal of square footage to be covered by the license
  - Location of the cultivation
  - Approved plan for compliance with all local/state/county rules and regulations
  - Approved compliant security plan
  - Payment of scaled licensing fee
- Renewal of a cultivation license requires the licensee to:
  - Report the square footage covered by the license
  - Report the location of the cultivation
  - Provide evidence of compliance with local/state/county rules and compliant security plan
  - Provide evidence of compliant security plan
  - Pay the scaled licensing fee
  - Submit evidence of business operation and tax data
- Subject to random inspections by the regulatory authority
- Grow must be permanent/non-mobile

(vii) Commercial Grow – 10,000+ square feet under cultivation

- A cultivation license is required. Approval of a cultivation license requires:
  - Proposal of square footage to be covered by the license
  - Location of the cultivation
  - Approved plan for compliance with all local/state/county rules and regulations
  - Payment of scaled licensing fee
- Renewal of a cultivation license requires the licensee to:
  - Report the square footage covered by the license
  - Report the location of the cultivation

    - Provide evidence of compliance with local/state/county rules and compliant security plan
    - Submit evidence of business operation and tax data
    - Pay the scaled licensing fee
- Subject to random inspections by the regulatory authority
- Grow must be permanent/non-mobile

(viii) Hemp only cultivation license

- Must only grow hemp
- No regulations in addition to current USDA regulations
- Can sell product in accordance with current USDA regulations
- Any cannabis produced and intended for use in any consumable item must be sold and delivered immediately to a licensed cultivator or disposed of immediately. Repeat instances of said production will obligate the hemp cultivator to obtain a cannabis cultivation license.
- Any hemp cultivator can accept cannabis waste from any cannabis market participant for use in non-consumable products (such as rope, plastic, building materials, etc…)

(ix) Cooperatives

- Any group of cultivation licensees whose cumulative, licensed square footage under cultivation is less than 5,000 square feet may obtain a cooperative license
- All coop members must individually abide by the requirements of their relevant cultivation licenses
- All coop members can sell directly to legal consumers on a single chosen member's agricultural, commercial, or industrial zoned land
- All sales to an end user must meet the regulatory authority's established testing and packaging requirements

b. Business Licensing

Recommendation: The state should establish a licensing process similar to that established for cultivation licenses for the following businesses: Manufacturing/Processing, Distribution, Delivery, Testing, Transportation, Retail Dispensary, and On-site Consumption. All consumer sales must be tested and packaged appropriately. Testing is not required for licensee-to-licensee sales. The regulating authority should investigate the feasibility of requiring a seed-to-sale tracking system.

Findings: A healthy cannabis industry includes a number of plant-touching businesses that will require licenses to operate in order for Hawaii's regulations to comply with the current federal enforcement priorities. At the same time, facilitating the growth of these additional plant-touching businesses will lay the groundwork for a flourishing industry in Hawaii that is ready to expand into additional markets in the future.

(i) Manufacturing/Processing

- This license covers any transformative activity to a product between cultivation of the raw cannabis and packaging of the product for retail – including extraction, rolling, cooking, etc…
- Licensees can accept detritus from all other market participants for processing
- Licensees can transport their own products.
- Obtaining/renewing a license will require:
  - Approved safety standard operating procedures
  - Approved manufacturing standards
  - (For renewal) Submit evidence of business operation and tax data
  - Demonstrated compliance with state/county building, zoning, other codes and permits as condition of license/renewal
  - Payment of license/renewal fee
- All licensees are subject to random inspections

(ii) Distribution

- This license covers the sale directly to retail locations of raw or packaged products bought from cultivation licensees or manufacturing/processor licensees by the distributor.
- Licensees can transport their own products.
- Obtaining/renewing a license will require:
  - Approved safety standard operating procedures
  - (For renewal) Submit evidence of business operation and tax data
  - Demonstrated compliance with state/county building, zoning, other codes and permits as condition of license/renewal
  - Payment of license/renewal fee
- All licensees are subject to random inspections

(iii) Delivery

- This license covers the delivery of products directly from retail locations to consumers, subject to transportation limits on the amount transported at any one time.
- This license can be restricted to social equity applicants as defined by the regulatory authority
- Obtaining/renewing a license will require:
  - (For renewal) Submit evidence of business operation and tax data
  - Payment of license/renewal fee
- All licensees are subject to random inspections

(iv) Testing

- Testing facilities should be licensed in accordance with current licensing requirements

(v) Transportation

- This license covers business-to-business transportation of large amounts of cannabis.

- Licensees can transport any amount of products at a time
- Obtaining/renewing a license will require:
  - (For renewal) Submit evidence of business operation and tax data
  - Payment of license/renewal fee
- All licensees are subject to random inspections

(vi) Retail Dispensary

- This license provides a single brick-and-mortar retail location that may market and sell cannabis products directly to consumers.
- Licensees can transport the products.
- Obtaining/renewing a license will require:
  - Approved safety standard operating procedures
  - (For renewal) Submit evidence of business operation, tax data, and an inventory audit
  - Demonstrated compliance with state/county building, zoning, other codes and permits as condition of license/renewal
  - Payment of license/renewal fee
  - Demonstrated compliance with all current restrictions on retail location sites
- All licensees are subject to random inspections
- Whether medical/adult-use licenses are included together in a single location or require separate licenses will be determined by the Medical Use Group

(vii) On-site Consumption

- This license can only be obtained as an add-on to a retail license for an additional fee. Each on-site consumption license will correspond to a single retail license and provide for a single brick and mortar location for on-site consumption that is physically united with the associated retail location.
- All retail licensee/renewal or requirements apply
- Every on-site consumption location requires a cold dark room and certified CPR on premises at all times
- Other restrictions to protect consumers can be implemented

2. <u>License Pricing</u>

<u>Recommendation</u>: Our proposal is to put the provision of cannabis cultivation licenses on a sliding license fee scale by size of operation. In this way, cultivators can choose how much to cultivate and how much to pay as a license fee each year in response to efficient market forces. This will help control cannabis cultivation business entrance and exits, cannabis prices, and privilege small local growers over large, multi-state operators. Other business license fees (including hemp cultivation and cooperative licenses) can be set per license type in accordance with similar goals, but we do not recommend a sliding scale for those license types – adjusting each license price over time should be sufficient to manage the supply of those licenses in the industry. The regulatory authority should have authority to set license prices for all license types and may consider requiring application fees.

Findings: As discussed above, Hawaii's licensing structure needs to adapt to the following considerations: (1) provide for the continuation of small individual grows; (2) allow for the easy transition of the legacy market into the new, legitimate licensee structure; (3) encourage small, artisanal farmers across the islands to take advantage of Hawaii's unique micro-climates and cannabis genetics; (4) create sufficient supply for both the local and tourism markets; (5) prioritize local ownership of cannabis businesses; (5) forestall the domination of the industry by large, multi-state operations; (6) continue to protect the safety of industry participants and consumers alike; and (7) and prepare Hawaii to compete as an exporter on the national and international stage over the next ten to twenty years. Additionally, there are very real concerns about market saturation raised in other sections of this report. Licensing fees are a powerful tool for managing industry participation by sending efficient market signals about the costs of doing business rather than by mandating license limits.

We present here an example of a sliding scale cultivation license fee structure under which a licensee can choose the size of its license fee according to the specific size of the grow operation. Such a non-linear, scaling structure privileges smaller growers and reduces the opportunity for large, out-of-state operators to dominate the industry. The lower costs for smaller growers also encourage the legacy market to enter the licensed system.

- Home Grow – Max 20 plants
    - No license required
- Commercial Grow – 20+ plants up to 499 square feet under cultivation
    - 0 sq. ft. to 499 sq. ft.
    - Scale linearly by number of sq. ft. at a rate of $1.00 to 1 sq. ft. from $500 to $1,000
- Commercial Grow – 500 to 999 square feet under cultivation
    - 500 sq. ft. to 999 sq. ft.
    - Scale linearly by number of sq. ft. at a rate of $3.00 to 1 sq. ft. from $1,000 to $2,500
- Commercial Grow – 1,000 to 4,999 square feet under cultivation
    - 1,000 sq. ft. to 4,999 sq. ft.
    - Scale linearly by number of sq. ft. at a rate of $4.00 to 1 sq. ft. from $2,500 to $18,500
- Commercial Grow – 5,000 to 9,999 square feet under cultivation
    - 1,000 sq. ft. to 4,999 sq. ft.
    - Scale linearly by number of sq. ft. at a rate of $6.00 to 1 sq. ft. from $30,000 to $60,000
- Commercial Grow – 10,000+ square feet under cultivation
    - Scale linearly by number of sq. ft. at a rate of $10.00 to 1 sq. ft. from $10,000 per 1,000 sq ft

3. License Structure.

Recommendation: The requirement of licensure of the key individual as well as the entity is an important means of evaluating both the entity licensee as well as the natural persons who run the organization and should be replicated for a dual license system. Review of the entity should include a background check of key participants, similar to the procedure set forth in

HAR §11-950-17. This requirement should only apply to retail/on-site consumption licensees and cultivation licensees with a cumulative (in case they apply for multiple smaller licenses) amount under canopy of 5,000 sq ft or more.

All licensees should be required to supply the name of every individual/person owner of the licensed entity and every individual/person owner of every entity with an ownership interest in the licensed entity.

The state should consider finding a legal way to require state residency for licensees. Colorado may be an acceptable model for this requirement.

Findings: Hawaii's Medical Cannabis Dispensary System law (Ch. 329D HRS) requires an application for a dispensary license to include both an individual and an entity application (HRS§329D-3; HAR §11-850-12) and sets forth documentation requirements for each license application. Background checks are required for all key individuals. This type of licensing structure that involves both the applying entity and its key principals is used in several other jurisdictions and ensures that there is a natural person that represents the business.

In addition, many jurisdictions provide for some level of oversight of all employees and subcontractors involved in the licensee operations that includes registration, certification or the issuance of an employee authorization card and may include a criminal history check. Hawaii places the responsibility for establishing policies, training and maintaining employee records on the licensee (See HAR §11-850-12, 11-850-35) and has badge requirements for operators, employees and subcontractors.

There are cost and practical benefits to delegating responsibility for employee tracking to licensees. However, given the difficulty in sharing personnel information outside an organization with the licensing authority or with prospective employers, it may be useful for the licensing authority to adopt some ability to revoke employee cards and require employee-applicants to attest that a prior authorization card did not result in disciplinary action, termination or revocation of a card.

C. Restrictions on Licensing

1. Challenges to oversupply and undersupply of cannabis

Recommendation**:** State-level monitoring of market variables such as cost of licensees, quantities of cannabis produced or sold (aggregate and per capita), timeliness of license approvals, and oversight of county time/place/manner restrictions is strongly encouraged.

Findings: An oversupply and undersupply of cannabis have created unique challenges in several other state jurisdictions.

In Oregon, for example, regulators have placed a pause on new licenses due to an abundance of regulated supply and a backlog in applications processing. In California, the relatively low number of licensed retail shops per capita compared to other jurisdictions may be a result of a combination of a thriving legacy market and the limited number of counties that have approved retail activity. In Illinois, there continues to be long lines and product shortages.

Colorado and Washington are among the more mature markets where wholesale cannabis prices have tumbled because growers produced far more flower than retailers could absorb ("*Adult-use cannabis companies struggle to stay afloat amid overproduction, falling prices*," by Patrick Maravelias, Reporter, June 27, 2022.)

Cannabis prices will naturally fall as the deregulated industry adjusts to an influx of customers and supply. Artificially prolonging that process by restricting licenses so that the price falls gradually overtime will incentivize overinvestment in business infrastructure reliant on current prices which will ensure that Hawaii's cannabis industry will not be able to compete in a national market. License restrictions may also negatively impact social equity.

According to the U.S. Bureau of Labor Statistics, approximately 20% of businesses fail in their first two years and 45% of businesses fail in their first five years. The regulating authority's job is not to ensure that businesses do not fail, but to provide support for them to succeed by providing relevant information about their industry, FAQs and guidance as to labelling and branding.

Note that the current law in Hawaii provides for as many as one dispensary license per 500 patients, each license includes three retail locations, which is one retail location per 167 patients. States like Oklahoma that have not placed limits on the number of retail licenses have seen the market settle in a similar place of ~200 consumers per retail location.

Alternative methods of managing the number of market participants and supply of cannabis is to give the governing body authority to adjust license requirements such as fees, to discourage new entrants when the market becomes saturated.

Additionally, Hawaii's higher land prices will serve to somewhat restrict speculation in cannabis cultivation in Hawaii. As will any method of controlling, regulating, or excluding foreign and mainland investors from monopolizing the industry.

2. <u>Foreign and Interstate Investors</u>

<u>Recommendations</u>: Adopt a disclosure requirement similar to that recently adopted in Oklahoma that would require applicants to attest to the identity of any foreign financial interest. https://www.obndd.ok.gov/registration-and-pmp/waivers/foreign-financial-interest. Verify the immigration status of any non-citizen individual applicant. Foreign investment also can be monitored during the required annual tax and business operation disclosures.

Interstate investor involvement cannot be directly banned. However, the legislature can explore several options for managing interstate involvement including: (1) Scaling license fees to encourage small growers rather than large growers, discouraging outside investment; (2) Enforcement of higher import/export restrictions on cannabis, similar to current agricultural inspection/regulations (similar to California's agricultural ban on bringing in farm products) (with the caveat that the export restrictions should be lifted to encourage domestic export when federally legal); (3) joining an interstate commerce pact; and (4) pursuing alternative methods of encouraging local ownership in cannabis businesses.

Findings: Other states have suffered from an influx of foreign and interstate investors, with. investors bringing questionable fiscal resources from overseas. They also control sufficient capital to create significant market inefficiencies in a new industry. Other states have seen a rash of businesses started and abandoned quickly to take advantage of the initial price bump in a state following adult-use implementation. These abandoned properties drive up home prices, are a blight on neighborhoods, and distort the local markets keeping local growers and operators out of the industry. Current Hawaii rules do not appear to preclude participation by foreign investors provided the criteria for licensure is met.

3. License consideration for cannabis criminal offenses

Recommendation: Defer to Social Equity Market Group.

Findings: In a manner similar to many other jurisdictions, additional license considerations have been afforded to applicants with prior cannabis criminal offenses.

4. Financial Integrity Requirements

Recommendation: The regulating authority should set scalable, minimum capitalization requirements depending on the type of license and size of cultivation. These requirements should be designed to facilitate the entry of small local business owners.

Recommendation: Replace the audit requirement (HRS 329D-23) with required submittals of evidence of business operations and tax data for license renewal. Because the regulatory authority will need to make timely data-driven review and analysis of cannabis data, retaining the operations data submission requirement would assist in making decisions to regulate the under/over supply of cannabis in the market.

Findings: While it is important that a dual system of cannabis regulation accommodate a diverse complement of business owners, applicants should meet certain minimum financial standards to qualify for licensure. This will help differentiate legitimate business operators from individuals who may join the industry to make a quick profit before leaving a mess and those who are most vulnerable to the business failure in a volatile market. These requirements should be scalable, depending upon the size of the entity and the nature of the license. Social equity applicants should be given low- or zero- interest loans to meet the minimum capitalization requirements.

5. Pre-license site inspection requirement

Recommendation. The application process should include a physical inspection of site by the regulatory authority in a manner similar to the procedure set forth in the state's liquor law. Consideration should be given to provide checklists to assist applicants in meeting the requirements of the physical inspections. Pre-site physical inspections should not be required for cultivation licenses under 500 sq ft or for delivery licenses. Technical assistance should be provided to social equity applicants in navigating the pre-inspection process. Given the long-application time for county building permits and associated cost to carry the property for several months or more, pre-site inspection should happen prior to the purchase or lease of a property to determine compliance with license requirements.

Findings: Many jurisdictions have an established protocol for pre-license inspection of activity sites, with some jurisdiction relying on county-level inspection. Hawaii in HRS §329D-6 sets forth dispensary operations requirements, including security requirements, labor requirements, hours of operation, use of a computer tracking system, and a requirement that the dispensary provide the state with basic information about the site. See also, HAR §11-850-32 and §11-850-33 that precludes the applicant from operating until the department approves the site.

In evaluating other Hawaii pre-license inspection requirements, it appears that the language that is most analogous to the cannabis regulatory language in other states is Hawaii's state liquor statute, HRS Chapter 281. Specifically, HRS 281-51 states:

§281-51 Prior inspection. No license shall be issued under this chapter unless and until the liquor commission has caused to be made a thorough inspection of the premises upon which the proposed business is to be conducted and is satisfied as to its fitness and that all other general conditions and proposed methods of operation under the license are such as are suitable for carrying on the business in a reputable way. "In a reputable way" includes among other considerations operating in such a manner that activities within the premises or in such adjacent related outdoor areas such as parking lots or lanais will not create noise in excess of standards contained in state or county noise or vibration codes which intrudes into nearby residential units. [L Sp 1933, c 40, §27; RL 1935, §2596; RL 1945, §7248; RL 1955, §159-50; HRS 281-51; am L 1975, c 55, §2]

One jurisdiction, Oklahoma, cited its lack of a pre-license site inspection as a significant drawback to its licensing program. Oklahoma as subsequently adopted periodic inspection requirements. In reviewing Oklahoma's license application, it appears that the applicant is able to attest to various licensing requirements without physical site inspection by the agency.

By comparison, this is Nevada's inspection rule:

5.070 Inspections.
1. Board Agents or the Executive Director may, at any time they determine an inspection is needed, conduct an investigation into the premises, facilities, qualifications of personnel, methods of operation, policies and procedures of any cannabis establishment and of any person proposing to engage in the operation of a cannabis establishment. An inspection of a facility may include, without limitation, investigation of standards for safety from fire on behalf of the Board by the local fire protection agency. If a local fire protection agency is not available, the State Fire Marshal may conduct the inspection after the cannabis establishment pays the appropriate fee to the State Fire Marshal for such inspection.
2. The Board will not issue a license for a cannabis establishment until the Board Agents complete an inspection of the cannabis establishment. Such an inspection may require more than one visit to the cannabis establishment.
3. Board Agents may conduct a preliminary walk-through of a cannabis establishment, upon

request and subject to the availability of inspectors, to assist with questions and identify issues for correction before the inspection of the cannabis establishment. Before requesting a preliminary walk-through, a cannabis establishment must complete all construction and be near completion of all other requirements of the laws and regulations of this State. If a Board Agent conducts a preliminary walk-through at the request of a cannabis establishment, the Board will issue an invoice to the cannabis establishment for the costs of the preliminary walk-through, including, without limitation, travel and inspection activities.
4. In addition to complying with the provisions of chapters 372A and 678B of NRS and chapter 372A of NAC governing the imposition of an excise tax on cannabis establishments, a cannabis establishment may not operate until it has been issued a license from the Board.
5. The Board will not issue a license for a cannabis establishment until the Board has received a satisfactory report of full compliance with and completion of all applicable public safety inspections required by state and local jurisdictions, including, without limitation, fire, building, health and air quality inspections, except as otherwise provided in NCCR 5.075.

D. Overseeing Authority

1. Scope of Adult-Use Legalization

Recommendation: While the specifics of decriminalization/descheduling/legalization are outside the purview of this Market Group, for a vibrant, effective, local industry to emerge that supplants the legacy market and brings current legacy participants into the legal market, the decriminalization/descheduling/legalization of cannabis should be substantial and all further enforcement should be handled directly and solely by the regulating authority as a civil matter in the same matter as the Department of Taxation regulates failure to pay taxes and tax evasion. To the extent that failure to obtain a license might result in criminal liability, such liability should only be enforceable upon referral of the matter to the State Attorney General.

The Market Group does highly recommend the legislature make every effort to ensure the new regulatory scheme places as much control of all enforcement of cannabis specific regulations – legal and illegal activities – inside the regulatory authority. The more agencies and overlapping jurisdictions exhibit authority over the cannabis specific regulations, the more regulatory costs will increase, to the benefit of the legacy market.

Findings: The scope of decriminalization/descheduling/legalization of the cannabis plant under a state adult-use regime will dramatically impact market structure. If the cannabis plant remains a Schedule I substance, and enforcement remains chiefly in the state and county public safety organizations, then the industry will struggle to grow in any meaningful way and will not compete with the gray market. If the cannabis plant is descheduled and most, if not all, interactions with the plant outside the new regulatory scheme are only subject to civil fines rather than criminal sanction, then there would be sufficient flexibility in the design of an efficient adult-use industry.

2. Labeling Requirements

Recommendation: In addition to "Made in Hawaii' labeling requirements, and for the protection of Hawaii grown cannabis and genetics, the Hawaii Department of Agriculture's "Seals of Quality" program should strongly be considered. This is particularly so in the future when Hawaii grown adult-use cannabis become eligible for export.

Findings: It is recognized that there is value in branding and a need for labeling requirements such as "Made in Hawaii." Such steps must be taken to protect Hawaii's unique cannabis genetics and worldwide brand before it is diluted and unprotectable.

3. Diverse Multi-Disciplinary Approach with Oversight Authority

Recommendation: Creating a smaller operating board (no more than five individuals) that is supported by a larger advisory board will provide for greater market and enforcement efficiency. A larger deliberative board may face vacancy and quorum issues and decision-making would be unwieldy. The Nevada Cannabis Compliance Board is an example of a small deliberative board (NRS 678A.360, 5 members with backgrounds in accounting, law enforcement, law, cannabis industry, and public health in the area of education and prevention of cannabis abuse) that is supported by an advisory board. An authoritative body would have the powers and duties to regulate and control its adult-use cannabis program with a well-defined mission statement outlining its governance similar to Nevada, Michigan, California, and Alaska.

The Advisory Board should include members with background in tax, health, agriculture, law, licensing, and economic development.

The Advisory Board's membership composite may include:

- Department of Health Director - Medical and Environmental Divisions or designee
- Department of Agriculture Director - or designee
- Department of Business, Economic Development and Tourism Director - or designee
- Department of Taxation Director - or designee
- Department of Commerce and Consumer Affairs Director - or designee
- Department of Public Safety Director - or designee
- Attorney General or designee
- Health Care provider
- Patient advocate
- Person with knowledge in the field of criminal justice reform
- 1 - 3 people actively engaged in the cannabis industry
- 1 - 2 laypersons

Duties of the boards may include:

- Recommending clear, consistent standards for licensure by promoting the highest level of public health and safety
- Keeping licensees, stakeholders, and the public informed and engaged in the Board's/Commission's mission
- Recommending clearly defined incentives and preferences for small business
- Providing accurate and timely data. As regulation in this area is relatively new and rapidly developing, accurate and timely data will be critically important to provide the

foundation for data-driven decision-making. The regulatory body should be afforded authority to make timely adjustments.

The regulatory authority should have discretion to manage every aspect of the cannabis program within the confines of the authorizing statutes, and it should be independent either within or separate from all current agencies, authorities, boards, or commissions.

The Market Group is also aware that the transition period between the legalization of cannabis and the setup of the managing agency and implementation of the licensing scheme will likely take a number of months if not over a year during which the market will operate with little oversight. The Market Group recommends that any enabling legislation include sufficient resources to effect a timely and orderly transition to a dual use system, including but not limited to personnel and operating funds, interim authority to address transitional changes to the market, and authority to temporarily augment existing resources with personal services contracts.

Findings: Many jurisdictions have statutory-established agencies, authorities, boards, or commissions to oversee their adult-use cannabis programs that includes a smaller, core licensing authority with decision-making responsibilities, supported by a larger and more diverse advisory board that can provide research, data, subject matter expertise, and recommendations for the licensing authority's consideration. See, e.g. Nevada Cannabis Compliance Board, supported by Cannabis Advisory Commission; New York Cannabis Control Board supported by New York State Cannabis Advisory Board. Some jurisdictions establish a regulatory agency with an advisory board. See, e.g. Oregon Liquor and Cannabis Commission, advisory to Medical Marijuana program; Maine Advisory Commission, advisory to the Maine Department of Administrative and Financial Services.

E. Other

1. Marijuana is a Federal Schedule I drug – Decriminalization/Descheduling/Legalization

Recommendation: Defer to Social Equity Market Group.

Findings: Consideration should be given to regulation that places necessary restrictions on the industry in order to withstand federal scrutiny, while providing the groundwork for more robust activity in anticipation of subsequent evolution of the federal stance. The federal government does not require any *specific restrictions* for a state's cannabis industry to be considered "well-regulated", rather, it is concerned with the *enforcement* of the regulations the state implements.

2. Cost of Regulation versus "Sin Taxes"

Recommendation: Defer to Tax and Social Equity Market Groups

Findings: The cost of regulation should be differentiated from "sin taxes" (taxes that cover societal costs created by consumption).

Regulatory fees should lead to program self-sufficiency. Societal costs associated with cannabis use disorder would need dedicated funding for treatment and education. These societal costs should be separate from social equity costs related to decriminalization.

3. Meaningful, realistic incorporation of the legacy market

Recommendation: Defer to Social Equity Market Group.

Findings: It is important to achieve meaningful, realistic incorporation of the legacy market and provide incentives to transition legacy market activity to regulated activity.

Failure to incorporate the legacy market and provide incentives will undermine the financial success of program stakeholders.

Signatures

Submitted by the Market Structure Permitted Interaction Group this 17th day of August, 2022.

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