



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Anthony Mata
Nanci Klein

SUBJECT: SEE BELOW

DATE: May 31, 2023

Approved

Date

6/2/2023

**SUBJECT: AMENDMENT TO TITLE 6 (BUSINESS LICENSES AND REGULATION)
OF THE SAN JOSE MUNICIPAL CODE FOR THE CANNABIS
REGULATORY PROGRAM**

RECOMMENDATION

- (a) Approve an ordinance amending Chapter 6.88 of Title 6 (Business Licenses and Regulations) of the San José Municipal Code to:
 - (1) Modify the annual external audit requirement;
 - (2) Add definitions to clarify cannabis business activities;
 - (3) Make other changes to better align with state regulations; and
 - (4) Make other technical, non-substantive, or formatting changes.
- (b) Adopt a resolution amending the Administrative Citation Schedule of Fines to add and update fines for violations of Chapter 6.88 of Title 6 of the San José Municipal Code related to the City's Cannabis Regulatory Program, making other administrative corrections, and repealing Resolution No. RES2023-143.
- (c) Accept staff's update on the Cannabis Equity Pilot Program.

SUMMARY AND OUTCOME

If adopted by City Council, the resulting changes to the San José Municipal Code will modify when annual external audits are required; clarify definitions of cannabis business activities; align City regulations with state regulations; and make other technical, non-substantive, or formatting changes within Chapter 6.88 of Title 6 of the San José Municipal Code. Adopting the above resolution will establish fines for sections added to and updated in Chapter 6.88 of the San José Municipal Code related to regulating medical and non-medical cannabis. A status update for the Cannabis Equity Pilot Program is provided.

BACKGROUND

Existing Regulatory Program

On June 17, 2014, the City Council approved a Medical Marijuana Regulatory Program (Program) to regulate the cultivation, manufacturing, and dispensing of medical marijuana in the City of San José which went into effect on July 18, 2014. By the December 18, 2015 deadline for San José collectives to obtain a Notice of Completed Registration, 16 medical marijuana collectives were registered in San José. On November 8, 2016, California voters approved Proposition 64, the Adult Use of Marijuana Act, which permits the non-medical use, adult use, or recreational use of cannabis by individuals aged 21 and older. Additionally, the proposition established a statewide regulatory and licensing system effective January 1, 2018, for cannabis cultivation, manufacturing, distribution, testing, and dispensing. All 16 former “collectives” converted to being cannabis businesses.

The City’s 16 registered cannabis businesses can conduct medical and non-medical cannabis activities. Currently, the registration process allows new businesses to apply for cannabis manufacturing, distribution, and testing and allows the 16 previously registered businesses to open a second retail storefront location. Additionally, in February 2022, City Council approved a pilot equity program for up to ten new equity-owned retail businesses. Potential equity applicants must successfully complete San Jose’s Cannabis Equity Business Academy to be eligible to apply for registration.

The City’s regulatory program has three components; 1) Chapter 20 of the Municipal Code, the Zoning Ordinance, which regulates where cannabis businesses can locate; 2) Chapter 6.88 of the Municipal Code, which sets forth operational and regulatory requirements; and 3) the City Manager Regulations which promulgates additional regulations necessary for administering the program, including the registration process. Prior to receiving a Notice of Completed Registration, cannabis businesses are required to obtain a Zoning Code Verification Certificate from the Department of Planning, Building and Code Enforcement. The Zoning Code Verification Certificate is non-transferable to a different location; each location needs its own Zoning Code Verification Certificate to determine whether the site met the provisions at the time of issuance.

City Council Direction

To address issues the industry has been facing in finding a compliant location in a commercial zoning district, at the November 1, 2022 meeting, City Council directed staff to return with further updates to the Zoning Ordinance criteria for cannabis retail storefronts. The zoning updates are covered separately under Item 10.3 on the June 13, 2023, City Council agenda. Staff was directed to assess modifying the annual external audit requirement at the Community and

Economic Development Committee meeting on June 28, 2021.¹ Staff did not propose any changes to the external audit requirement at the February 15, 2022² City Council meeting; however, staff is proposing a modification in this memorandum.

ANALYSIS

This memorandum provides an update on staff's continued review of the cannabis regulatory provisions. The land use item and zoning options are discussed in the May 24, 2023, Planning Commission memorandum and will be reported to City Council under Item 10.3 at the June 13, 2023, City Council meeting.

Recommendation (a)(1): Modify the Annual External Audit Requirement

When the ordinance was originally passed in 2014 and prior to a state regulatory program, the City required each cannabis collective to submit an annual audit of its financial operations, completed and issued by an independent certified public accountant in accordance with generally accepted accounting principles. In January 2019, Section 6.88.600 of the San José Municipal Code was updated requiring each cannabis business to annually submit to the City either an audit (more in-depth evaluation that provides reasonable assurance) or a review (less in-depth information that provides limited assurance) once they receive (and maintain) an unqualified opinion on their financial operations. This update provided cannabis businesses with a less costly option for external audit services while maintaining controls around financial operations. The City's Finance Department is responsible for conducting cannabis business tax and sales tax audits and the Police Department regulates the cannabis business operations and conducts site inspections.

Feedback from the cannabis businesses has been that the audits are costly, which could present another barrier to entry for new equity business owners, and frequently cannot be completed on time. They have reported difficulty in finding Certified Public Accountants (CPA) willing to perform the required work due to the federal prohibition on cannabis and the perceived risk to them for providing services to a federally prohibited business. The industry does not dispute the value of audits generally and requested that the required annual audits be removed or changed to a punitive action if a business has a large tax audit finding rather than being an annual mandatory requirement.

City staff reviews the independent audits/reviews received by the cannabis businesses as part of the audit risk assessment. The independent audits provide insight into the nature of business operations and financials and serve as an independent source of financial information, which is

¹ June 28, 2021 Community and Economic Development Committee Meeting, Item (d) 3.
<https://sanjose.legistar.com/LegislationDetail.aspx?ID=4975752&GUID=4252DF5C-C2F1-4AAE-93F1-D2D9CED78729>

² February 15, 2022 City Council Meeting, Item 10.2 (c).
<https://sanjose.legistar.com/View.ashx?M=F&ID=10508904&GUID=D57B1C4A-9471-4292-B072-5E61D9336704>

valuable in the City's Cannabis Business Tax audit process. Staff does not support removing the external audit requirement from the San José Municipal Code; however, staff is proposing to modify the audit requirement. Instead of requiring an external audit on an annual basis, staff proposes changing the audit requirement to an as-needed basis contingent on elevated risks such as tax findings or improper internal controls.

Recommendation (a) (2) (3) and (4) - Municipal Code Updates

The draft ordinance contains several language changes/technical changes to update and clarify the San José Municipal Code with respect to the definitions, general provisions, operating regulations and conditions, records, and other administrative changes. Additionally, there are updates to align the City's regulations with state regulations regarding making a material physical change, alteration, or modification of a registered location or premises.

Recommendation (b) - Cannabis Regulatory Program Fines

Compliance with the City's Municipal Code can improve when administrative fines are reasonable and proportional to the violation being cited. In addition, escalating fines for repeat violations tend to further encourage compliance with the Municipal Code. Accordingly, the changes being proposed to the Administrative Citation Schedule of Fines establish appropriate fines for violations of Chapter 6.88 for delivery-only sites consistent with previously established fines and expand the fine schedule to include all cannabis business activity sites (manufacturing, distribution, combined manufacturing/distribution, and testing laboratory). In addition, this action corrects an administrative error in updating the Administration Citation Schedule of Fines to include fines for Chapter 17.85, the Energy and Water Building Performance Ordinance, previously adopted by Council Resolution No. 78892.

Recommendation (c) - Cannabis Equity Pilot Program Update

The Cannabis Equity Pilot Program offers an opportunity to residents who may have been harmed by years of cannabis prohibition and the "War on Drugs" to become business owners or start careers in the cannabis industry. At the February 15, 2022 meeting, City Council approved establishing the program and reserving up to 10 new registrations exclusively for participants in the program. The cannabis equity program is funded by a grant awarded to the City of San Jose by the California Department of Cannabis Control.

The Office of Economic Development and Cultural Affairs published a Request for Proposals to establish the Cannabis Equity Pilot Program in June 2022. A selection panel was established comprising representatives from the Police Department's Division of Cannabis Regulation, the City Manager's Office of Racial Equity, and the Office of Economic Development and Cultural Affairs to review responses to the Request for Proposals. Eight proposals were received, and the selection process proved to be highly competitive. A Notice of Intent to Award was issued to the California Asian Pacific Chamber of Commerce. The program from the California Asian Pacific Chamber of Commerce is centered on establishing an open access self-paced entrepreneurship-

led model using the expertise and experience gained from delivering similar programs across California.

The Office of Economic Development and Cultural Affairs requested the California Department of Cannabis Control extend the grant expiration date beyond December 30, 2022. The California Department of Cannabis Control would not extend the contract and the contract could not be executed. An alternative strategy was identified and on December 13, 2022, City Council approved the use of a fiscal agent – the Enterprise Foundation – to disperse the funds enabling the program to proceed. In early 2023, the Office of Economic Development and Cultural Affairs negotiated a Memorandum of Understanding between the California Asian Pacific Chamber of Commerce and the Enterprise Foundation.

Since the summer of 2022, over 80 residents expressed an interest in joining the Cannabis Equity Pilot Program. An online application process was launched in early 2023 and to date, approximately 30 residents have completed the form and are undergoing the necessary background checks. The program is designed to offer open enrollment for up to 90 residents and will operate until May 2024. Eligible residents are able to join through the end of January 2024.

The Cannabis Equity Pilot Program was launched at City Hall with the Office of Economic Development and Cultural Affairs, the Police Department Division of Cannabis Regulation, and California Asian Pacific Chamber of Commerce on May 15, 2023. The program is operational and will be subject to regular performance and evaluative review. The Office of Economic Development and Cultural Affairs continues to provide a direct service supporting residents to promote the program and assist with the equity academy application process. Staff is aiming to apply to the California Department of Cannabis Control for a new grant in the Fall of 2023. A further update will be provided to City Council by December 2023.

EVALUATION AND FOLLOW-UP

The Administration has consistently provided City Council with updates via informational memoranda regarding the progress of the City’s cannabis regulatory program, changes in state law, and other developments potentially impacting the regulatory landscape. Staff will provide another update regarding the Cannabis Equity Pilot Program by the end of 2023.

COST SUMMARY/IMPLICATIONS

Cannabis Regulation Program is based on regulatory and enforcement operations related to the 16 registered cannabis businesses. The Cannabis Regulation Program is effectually a cost neutral operation, in which costs are recovered from the businesses it regulates and monitors. The costs for the program are paid by the registered businesses in their annual registration fee and other fees-for-service. Fees are revised annually with the Proposed Fees and Charges Report in conjunction with the Proposed Operating Budget. As the program grows and changes any

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additional expenses related to proper and efficient regulatory and enforcement of the businesses will subsequently be charged over to them. Staff will monitor and return to City Council with recommendations through the budget process.

Currently, the Cannabis Business Tax rate for cultivation is 4%, manufacturing is 3%, distribution is 2%, laboratory testing is 0%, and retail is 10%. In 2021-2022, the City received approximately \$18.0 million in Cannabis Business Tax. Based on current collection trends, it is anticipated Cannabis Business Tax receipts will total \$15.8 million in 2022-2023, which is 12.5% below the prior year's level. These revenues are expected to increase once additional equity-owned businesses are opened and the 16 Registered Businesses open second retail locations. Staff will monitor actual collections and bring forward recommended budget adjustments, as appropriate through the budget process.

COORDINATION

This memorandum was coordinated with the City Attorney's Office, the City Manager's Budget Office, the Finance Department, and the Department of Planning, Building, and Code Enforcement.

PUBLIC OUTREACH

This memorandum will be posted on the City's Council Agenda website for the June 13, 2023 City Council meeting, and a link will be sent to the Police Department's cannabis email list. Staff will continue to engage the local cannabis industry and community-based organizations to promote the Cannabis Equity Pilot Program.

COMMISSION RECOMMENDATION AND INPUT

No commission recommendation or input is associated with this action.

CEQA

Not a Project, File No. PP17-008, General Procedure and Policy Making resulting in no changes to the physical environment.

PUBLIC SUBSIDY REPORTING

This item does not include a public subsidy as defined in section 53083 or 53083.1 of the California Government Code or the City's Open Government Resolution.

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Chief of Police

For questions regarding cannabis regulations and operations, please contact Wendy Sollazzi, Division Manager, Division of Cannabis Regulation, San José Police Department, at wendy.sollazzi@sanjoseca.gov or (408) 537-9890.

For questions regarding the Cannabis Equity Pilot Program, please contact Victor Farlie, Assistant to the City Manager, at victor.farlie@sanjoseca.gov or (408) 535-8230.