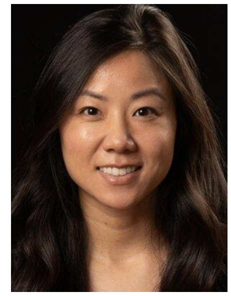
Why SEC's Cannabis Stock Promotion Case Is One To Watch

By **Jihee Ahn** (January 19, 2023)



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It looks like the U.S. Securities and Exchange Commission has its eye on the cannabis industry for alleged stock promotion schemes, also called anti-touting violations.

On Sept. 30, 2022, the commission filed a lawsuit, SEC v. Mikula, in the U.S. District Court for the Central District of California.[1]

In sum, the SEC announced charges against two companies, Sway Energy Corp. and Emerald Health Pharmaceuticals Inc., and their associated officers and directors, for their involvement in "a fraudulent scheme to promote the securities" of companies Elegance Brands Inc., Emerald Health, Hightimes Holding Corp., and Cloudastructure Inc. Elegance Brands produces a product called Gorilla Hemp, a CBD energy drink.

Most recently, the primary individual defendant, Jonathan Mikula, filed a motion to dismiss the claims against him on Jan. 6.

The case is one to watch given its potential impact on the cannabis industry at large — especially in light of Mikula's pending motion to dismiss, which argues the SEC must prove a specific scienter requirement to successfully plead its securities violation claims against him.

What Is a Stock Promotion Scheme?

Stock promotion schemes involve scenarios where public companies hire promoters or marketing firms to generate publicity for their stocks, and those promoters or marketing firms publish articles boosting those stocks — while failing to publicly disclose that they're receiving payments from the companies.

Those writers will post seemingly unbiased, glowing articles or reviews about the companies that are really nothing more than paid advertisements. Sometimes, the number of articles can get into the hundreds, and they sometimes even go so far as to affirmatively state that the writers have not been compensated by the companies they're writing about, when in fact they were.

Stock promotion schemes are dangerous, and they caught the SEC's attention in the late 2010s because so many members of the public depended on these articles to make their own investing decisions, sometimes to their severe detriment.

In fact, in a 2017 press release, Stephanie Avakian, then-acting director of the SEC's Division of Enforcement, stated:

> If a company pays someone to publish or publicize articles about its stock, it must be disclosed to the investing public. These companies, promoters, and writers allegedly misled investors by disguising paid promotions as objective and independent analyses.[2]

The SEC v. Mikula Complaint

The complaint[3] at issue alleges Mikula unlawfully promoted the securities of four issuers without disclosing the fact that he was paid for those promotions. Mikula allegedly promoted the securities through a newsletter called Palm Beach Venture.

As one example, one of his articles stated on behalf of Elegance Brands that its CBD product, Gorilla Hemp, was retailing for $3.95 per can and could ultimately yield Elegance Brands a 2,630% price increase, and that there were distribution agreements in place which could potentially increase Elegance Brands' share price by 9,900% in five years.

He presented his recommendations to therefore invest in Elegance Brands as unbiased and not paid for, even though he actually was compensated via cash and extravagant expenses.[4]

Mikula's associates were also charged for acting as middlemen — they allegedly arranged to receive a percentage of investor funds under the guise of consulting agreements with the companies.

And of course, the companies themselves were charged as having participated in the schemes and having made material misrepresentations and omissions in SEC filings and other investor materials.

The complaint further alleges that investors purchased approximately $80 million in the securities offered by these companies after the fraudulent promotion. No wonder it caught the SEC's attention.

The Defendants' Positions

Between the filing of the complaint and December 2022, most of the parties agreed to settle with the SEC by agreeing to permanent injunctions. They also agreed to "pay a combined total of $2.5 million to settle fraud charges against them," according to an SEC press release.[5] And the individuals agreed to various bans from serving as officers and directors of any company.

However, Mikula and one of his associates have yet to settle. For his own part, Mikula and his legal team filed a motion to dismiss the SEC's claims against him on Jan. 6.

In broad strokes, the motion to dismiss argues the SEC failed to plead all facts required by the statute to allege an anti-touting violation. Mikula's position is that this failure affects all five claims for relief against him, which include violations of:

- Section 10(b) of the Securities Exchange Act and Rule 10b-5(a) and (c);
- Section 10(b) of the Exchange Act and Rule 10b-5(b);
- Section 17(a)(1) and (3) of the Securities Act;
- Section 17(a)(2) of the Securities Act; and
- Section 17(b) of the Securities Act.

He cites Section 17(b) of the Securities Act, which states:

> It shall be unlawful for any person … to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which … describes such security for a consideration received or to be

> received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt.

Mikula's position is that the SEC has done nothing more than quote buzzwords of the statute as a legal conclusion; it wholly fails to factually allege that Mikula published articles about the stocks for a consideration received from the issuers.

His position is that receiving payment, even from an issuer, isn't enough — there must be a causal element demonstrating that the article's publishing occurred for the consideration received. Here, the SEC's allegations within the complaint do not specifically allege that the issuers' money caused Mikula's publication.

Of course, this essentially amounts to a position that scienter should be pleaded as an additional element of anti-touting allegations.

Mikula's motion to dismiss notes that neither the U.S. Supreme Court nor the U.S. Court of Appeals for the Ninth Circuit have ruled on the exact question of whether the SEC must plead and prove scienter to state a violation of Section 17(b). However, relevant case law certainly has impliedly inserted an element of fraudulent intent in prior situations.

Additionally, Mikula argues that the core conduct is analogous to the federal bribery criminal statute, where the Supreme Court implied a requirement that there be a showing that a defendant acted corruptly.

His motion to dismiss also generally argues the SEC failed to plead its fraud claims with particularity, and that the SEC proceeded in an improper venue, or the case should be transferred to a more convenient forum for the remaining defendants.

The motion to dismiss will be fully briefed and heard on Feb. 17 by the U.S. District Judge Stanley Blumenfeld.

Takeaways

While the SEC's pursuit of stock promotion schemes is no new development, their attention to the cannabis industry makes sense in light of the fact that securities violations and associated lawsuits have now abounded for years, and the public is increasingly interested in both consuming and investing in the space.

This case is certainly one to be watched — both as a potential cautionary tale and as potentially precedent-setting in securities law.

In terms of being a cautionary tale, this case serves as a good reminder that the SEC considers stock promotion schemes to be a huge threat to the investing public. In 2017, Melissa Hodgman, then-associate director of the SEC's Division of Enforcement, stated in a press release,

> Our markets cannot operate fairly when there are deliberate efforts to reach prospective investors with positive articles about a stock while hiding that the companies paid for those articles.[6]

In an attempt to ensure that purportedly objective investment information is what it claims to be, the SEC has historically settled for high amounts of disgorgement or penalties, as well as injunctive relief.

In terms of being potentially precedent-setting in securities law, Mikula's position that the SEC must specifically plead a scienter requirement is not squarely addressed by the courts.

He is asking the court to demand the SEC prove he acted with the requisite scienter by proving he had a certain fraudulent state of mind, i.e., intending to mislead the investing public.

While it's up for debate on whether this should be required, especially in order to get past just the pleadings stage, plenty of law in analogous situations do require a high bar in demonstrating scienter to avoid early dismissal, such as fraudulently inducing a shareholder to buy or retain shares, or insider trading.

If the court is sympathetic to Mikula's position, it may make for significant case law that could make it harder for the SEC to pursue stock promotion schemers. This would essentially create an additional factor the SEC to prove — scienter — which is often a fact-intensive inquiry that is difficult to establish, especially in advance of discovery.

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[1] Case no. 2:22-cv-07096.

[2] https://www.sec.gov/news/press-release/2017-79.

[3] https://www.sec.gov/litigation/complaints/2022/comp-pr2022-182.pdf.

[4] https://www.sec.gov/litigation/litreleases/2022/lr25541.htm.

[5] https://www.sec.gov/news/press-release/2022-182.

[6] See note 2.