Microcap Update: SEC Reminds Issuers to be Compliance-Oriented When it Comes to Investor Relations

May 4, 2017 Greg Kramer

PRACTICES Capital Markets and Securities, Corporate

Earlier this spring the SEC announced enforcement actions against 27 individuals and entities behind stock promotion schemes. When we hear about stock promotion schemes, we tend to think about grey sheet stocks issued by companies with little real business activity and limited public information. However, this SEC enforcement sweep included three exchange listed companies. So while it may be tempting to dismiss this recent SEC investigation as irrelevant to all the good microcap companies that are exchange listed and have real businesses and technologies, the sweep underscores a tension that is very relevant: the need for microcap issuers to increase their profile in the marketplace and frequently raise capital while complying with numerous and complex securities laws and playing defense against an aggressive and talented plaintiffs' bar.

The SEC's investigation focused on violations of Section 17(b) of the Securities Exchange Act of 1934, which prohibits any person from publishing, giving publicity to, or circulating any communication that describes a security in exchange for direct or indirect consideration from an issuer, underwriter or deal without fully disclosing the past or prospective consideration and the amount of such consideration. The SEC uncovered scenarios in which public companies hired investor relations firms to generate publicity for their stocks, and the firms subsequently hired writers to publish articles that did not publicly disclose the payments from the companies. In all three enforcement actions against public companies, the SEC alleged that the companies knew or were reckless in not knowing that the investor relations firms would either not disclose compensation or would affirmatively misrepresent that the author had not been compensated. Two of the companies involved in the sweep were also found to have violated Section 5 of the Securities Act of 1933 by engaging in improper "gun jumping" because the articles were transmitted while the companies were offering their securities to the public.

The consequences for the involved companies, and in one instance an officer of one the companies involved, may be long reaching and severe. Each of the three companies involved in the investigation agreed to cease and desist from future violations of securities laws, two of the companies paid civil monetary penalties, and an officer of one of the companies was personally liable for civil monetary damages and banned from serving as an officer or director of a public company for five years. The three companies may also be subject to "bad actor" disqualification under Rule 506(d), which would prohibit them from relying on an important private offering exemption. All three of the companies involved in the investigation are currently subject to private class action lawsuits.

Here are some key takeaways:

- Investor relations activity is needed by microcap issuers due to lack of analyst coverage and market visibility, but there needs to be attention to compliance issues.

- The SEC can apply a recklessness standard to companies with respect to their investor relations firms' violations of securities laws, so issuers need to take steps to confirm that their investor relations firms are complying with the law.
- Microcap issuers frequently raise capital and, accordingly, investor relations activity should be coordinated with securities counsel to avoid unwittingly violating the Securities Act.