Published on *The National Law Review* https://natlawreview.com

SEC Scrutinizes “Fake News” Stock Promotion Schemes

Article By:

Jason Zuckerman

Matthew Stock

SEC Enforcement Action Targeting Stock Promotion Schemes

On April 10, 2017, the ***SEC*** announced enforcement actions against 27 individuals and entities for improper stock promotion schemes. According to the press release, the SEC uncovered scenarios in which public companies hired communication firms to generate publicity for their stocks, and the firms subsequently hired writers to publish articles promoting the stocks and failing to disclose payment from the companies. The scheme entailed more than 250 articles that “left investors with the impression they were reading independent, unbiased analyses on investing websites” when in fact they were reading paid advertisements.

Although “fake news” is rampant around the Internet, the SEC’s recent enforcement actions underscore the agency’s commitment to weeding out this deception when it relates to investments. The Associate Director of the SEC’s Division of Enforcement, Melissa Hodgman, stated: “Deception takes many forms. 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.”

The SEC also released an investor alert warning about these schemes. According to the alert, microcap stocks may be particularly susceptible to undisclosed paid stock promotions that appear to be unbiased sources of information (as well as other forms of market manipulation). This investor alert suggests there may be ongoing violations in this area, which represents an opportunity for SEC whistleblowers to earn a reward.

SEC Whistleblower Program

Under the SEC Whistleblower Program, whistleblowers may be eligible for monetary awards when they voluntarily provide the SEC with original information about violations of federal securities laws that leads to a successful enforcement action resulting in monetary sanctions exceeding $1,000,000. Whistleblowers are eligible to receive between 10% and 30% of the monetary sanctions collected.

The SEC Whistleblower Program also protects the confidentiality of whistleblowers and does not disclose information that might directly or indirectly reveal a whistleblower’s identity. In fact, whistleblowers can even submit a tip anonymously if represented by counsel.

Since the law went into effect, the SEC Whistleblower Office has awarded more than $149 million to 41 whistleblowers. The largest award to date is more than $30 million. In 2016, the office issued more than $57 million in awards to whistleblowers.

Examples of Investment Violations and Securities Fraud

The SEC defines investment companies as any corporation, business trust, partnership, or limited liability company that issues securities and is primarily engaged in the business of investing in securities. In addition to the above-mentioned "fake news" enforcement actions, the SEC may bring enforcement actions for a host of other investment violations and fraud, including:

1. Failing to disclose fees, charges, and conflicts of interest;
2. Failing to maintain adequate written policies and procedures;
3. Parking and Steering;
4. False or misleading advertising; and
5. Failing to safeguard customer data.

In the past few years, these notable areas of investment violations and fraud have produced substantial settlements and penalties. See below for examples.

1. Failing to Disclose Fees, Charges, or Conflicts of Interest

Section 206 of the Investment Advisers Act of 1940 (IAA) prohibits fraudulent and deceptive conduct, and Section 207 proscribes material misstatements in investment adviser registration applications or reports. The SEC relies on these statutory authorities to bring enforcement actions when investment advisers fail to disclose conflicts of interest, as well as client fees or charges.

For example, in December 2015, two JP Morgan wealth management subsidiaries agreed to pay $267 million to settle charges that they failed to disclose conflicts of interest to clients. According to the SEC order, the investment advisory business and the bank invested clients in the firm's own proprietary investment products without properly disclosing this preference. In a parallel action, JP Morgan Chase Bank agreed to pay an additional $40 million penalty to the U.S. Commodity Futures Trading Commission (CFTC). (Note: the CFTC also has a whistleblower program that offers rewards for original information that leads to successful enforcement actions.)

In the SEC's press release, the Director of the Enforcement Division, Andrew J. Ceresney, stressed the importance of adequate disclosure concerning conflicts of interest. He stated: "Firms have an obligation to communicate all conflicts so a client can fairly judge the investment advice they are receiving. These J.P. Morgan subsidiaries failed to disclose that they preferred to invest client money in firm-managed mutual funds and hedge funds, and clients were denied all the facts to determine why investment decisions were being made by their investment advisers."

Other notable recent actions for failures to disclose conflicts, fees, or charges include:

- In October 2015, three private equity fund advisers within the Blackstone Group paid almost $39 million to resolve allegations they violated Section 206 for failing to disclose accelerated monitoring fees and a conflict of interest. Nearly $29 million was returned to investors;

- In November 2015, Fenway Partners LLP and four of its employees paid more than $10 million to settle charges that it violated Section 206 by failing to disclose a conflict of interest regarding the payment of fund and portfolio company assets to former employees and an affiliated entity.

- In September 2016, WL Ross & Co. LLC paid $2.3 million to resolve charges that it failed to disclose material information regarding fee allocation practices, in violation of Sections 206(2) and 206(4).

2. Failing to Maintain Adequate Written Policies and Procedures

Rule 206(4)-7 requires investment advisers to maintain written and policies and procedures reasonably designed to prevent violations of the IAA. An investment adviser's failure to do so violates Section 206(4). The SEC routinely enforces this provision in conjunction with other charges. Some of the cases above included charges that the investment advisers also violated Rule 206(4)-7. Other examples include:

- On August 23, 2016, four private equity fund advisers affiliated with Apollo Global Management agreed to a $52.7 million settlement to resolve a variety of charges, including that the advisers violated Section 206(4) and Rule 206(4)-7 by failing to maintain adequate policies and procedures.

- On September 14, 2016, First Reserve Management LP resolved allegations, including that it had violated Rule 206(4)-7, for $3.5 million.

3. Parking and Steering

Parking and steering schemes may constitute fraudulent practices in violation of Section 206. Parking is a practice of prearranged trading that benefits one account over another. Unlawful steering occurs when an investment adviser directs a client to investments that will generate higher fees for the adviser, without disclosing the conflict of interest to clients. Recent parking and steering cases include:

- In December 2015, Morgan Stanley Investment Management agreed to pay $8.8 million to resolve the SEC's claim that a portfolio manager colluded with a brokerage firm trader to trade at prearranged prices to the benefit of some client accounts, but the detriment of others.

- In March 2016, three AIG affiliates paid more than $9.5 million to settle charges that they steered clients to investments that put unnecessary charges on the investor but generated an additional $2 million in fees without disclosing the conflict of interest.

4. False or Misleading Advertising

Section 206 of the IAA, and Rule 206(4)-1 in particular, also regulates investment advisers' advertisements. The rule limits testimonials and recommendations and prohibits false and misleading advertising. For example:

- In August 2016, thirteen investment advisory firms paid varying penalties for a total of $2.2 million to settle allegations that they spread false claims made by investment management firms about its flagship product.

5. Failing to Safeguard Customer Data

Morgan Stanley Smith Barney LLC agreed to pay a $1 million penalty to settle charges for its failure to protect customer data. According to the SEC order, the firm did not adopt written policies and procedures reasonably designed to protect customer data. Some of the data was hacked and even offered for sale online.

According to PwC's 2016 crime survey, economic crime has outpaced company preparedness and, as a result, U.S. organizations have experienced an increase in cybercrime compared to prior years. This will continue to be priority enforcement area for the SEC. Companies should ensure compliance with federal securities laws, which require investment companies to adopt written policies and procedures reasonably designed to protect customer records and information.

Negligent Conduct Violates the Investment Advised Act

Unlike many other laws dealing with fraudulent conduct, the IAA may be violated when the investment adviser is merely negligent, as opposed to specifically intending to defraud a client. For example, because Section 206(2) prohibits conduct that *operates* as a fraud, an investment adviser may engage in prohibited conduct merely through negligence.

National Law Review, Volume VII, Number 103