

SEC Investigation Shows Maturation Of Cannabis Scrutiny

By **Stephen Ascher, Martin Glass, Andrew Lichtman, Charles Riely and Howard Suskin**
 March 31, 2020, 4:27 PM EDT

The U.S. Securities and Exchange Commission is investigating cannabis giant Cronos Group Inc. for potential accounting irregularities. Although the SEC has devoted significant resources to root out offering fraud and market manipulation in marijuana-related penny stocks, this appears to be the SEC's first publicly reported investigation into a major cannabis company.

According to reports, the SEC's inquiry follows a self-disclosure by Cronos relating to its revenue recognition practices.[1] If this inquiry signals that the SEC is turning its focus to more mature marijuana-related businesses, or MRBs, the SEC will be able to draw from its well-developed playbook for investigating accounting irregularities, including closely reviewing a company's sales and income for evidence that insiders manipulated earnings or revenue to make quarterly targets.

In reviewing a MRB, the SEC may also take a close look at how the company disclosed the unique risks associated with conducting business in an industry that remains illegal at the federal level.

Toronto-based Cronos is one of the largest cannabis producers and distributors in the world. Like several other Canadian MRBs, Cronos is registered with the SEC and its stock is listed on a U.S. exchange.

On Feb. 24, Cronos announced it would delay its fourth quarter and full-year 2019 financial results.[2] A week later, Cronos filed a notification of late filing with the SEC, disclosing that:

The Company has been unable to complete its financial statements for fiscal 2019 due to a continuing review by the Audit Committee of the Company's Board of Directors, with the assistance of outside counsel and forensic accountants, of several bulk resin purchases and sales of products through the wholesale channel and the appropriateness of the recognition of revenue from those transactions.[3]

A securities class action on behalf of Cronos' shareholders quickly followed this disclosure. On March 11, a complaint was filed in the U.S. District Court for the Eastern District of New York alleging that Cronos "made false and/or misleading statements and/or failed to disclose" that (1) "Cronos had engaged in significant transactions for



Stephen Ascher



Martin Glass



Andrew Lichtman



Charles Riely



Howard Suskin

which its revenue recognition was inappropriate,” and (2) “the foregoing would foreseeably necessitate reviews that would delay the Company’s ability to timely file its period reports.”[4]

At first blush, nothing about the Cronos complaint seemed out of step with recent actions in the industry. Indeed, plaintiffs firms, which are hungry to cash in on the widespread stock drops in the cannabis industry, have filed many securities class actions against MRBs in the last year.[5]

However, unlike in those other cases, public reports indicate that the SEC’s Division of Enforcement has launched a parallel investigation into Cronos. On March 19, MarketWatch reported that it had reviewed internal Cronos communications dated March 10, which confirmed the SEC “requested that the company retain and preserve all records about revenue recognition related to bulk-resin purchases and wholesales of biomass or other products.”[6]

The investigation appears to be in response to Cronos’ announcement that it would delay its fourth quarter filings and its recent announcement that it would restate and reissue its previously issued unaudited interim financial statements for the first, second and third quarters of 2019.[7]

According to the press release, the company’s audit committee “has been conducting a review of certain bulk resin purchases and sales of products through the wholesale channel, and the restatement is being made to eliminate certain of these transactions through the wholesale channel.”[8]

The fact that the SEC followed up on a self-disclosure of accounting irregularities, of course, is not news. The SEC has long been focused on accounting irregularities in public companies, and in recent years, has brought dozens of cases against public companies for accounting failures. These cases have ranged from cases against companies for violation of the internal control provisions to more serious cases alleging violation of the anti-fraud statutes.

What is new is that the SEC is looking at an MRB for accounting irregularities. In recent years, the SEC’s main focus in the MRB space was preventing wrongdoers from using enthusiasm for the investment opportunities provided by possible legalization of marijuana to invest in dubious penny stocks.[9]

The SEC issued an investor alert for marijuana-related investments in September 2018 and brought a series of actions alleging offering fraud or market manipulation in penny stocks.[10]

If the SEC turns its focus to more mature MRBs, it will be able to draw from its well-developed playbook for investigating accounting irregularities. This includes closely reviewing a company’s sales and income to see evidence that insiders manipulated earnings or revenue to make quarterly targets.

The SEC may also scrutinize how the company disclosed the unique risks of grappling with the contours of a product that remains illegal at the federal level and for which interpretation and application of accounting rules may entail atypical considerations.

The SEC’s inquiry appears to show that the SEC will apply traditional enforcement scrutiny to MRBs, specifically, launching a preliminary inquiry following a company’s self-reporting of potential deficiencies with its previously-issued financial statements.

It remains to be seen, however, whether this is an isolated incident or whether this signals a broader, industry-wide sweep. In the meantime, SEC-registered MRBs should make sure that they are complying with applicable securities laws and regulations.

Stephen L. Ascher is a partner and co-chair of the securities litigation and enforcement practice at Jenner & Block LLP.

Martin C. Glass is a partner at the firm and co-chair of the firm's cross-border transactions practice.

Andrew J. Lichtman is a partner at the firm.

Charles D. Riely is a partner at the firm. He was previously an assistant regional director for the SEC's Division of Enforcement.

Howard S. Suskin is a partner and co-chair of Jenner & Block's securities litigation and enforcement practice and the class action practice.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] <https://www.marketwatch.com/story/exclusive-pot-company-cronos-receives-sec-inquiry-2020-03-19>.

[2] <https://www.globenewswire.com/news-release/2020/02/24/1989155/0/en/Cronos-Group-to-Delay-2019-Fourth-Quarter-and-Full-Year-Earnings-Release-and-Conference-Call.html>.

[3] <https://www.sec.gov/Archives/edgar/data/1656472/000165647220000012/cronos12b-25.htm>.

[4] *Witte v. Cronos Group Inc., et al.*, No. 20-cv-1310 (E.D.N.Y. Mar. 11, 2020).

[5] See, e.g., *Monica Acerra v. Trulieve Cannabis Corp.*, 20-cv-775 (E.D.N.Y. Feb. 12, 2020); *Eduardo Ortiz v. Canopy Growth Corp., et al.*, No. 19-cv-20543 (D.N.J. Nov. 20, 2019).

[6] <https://www.marketwatch.com/story/exclusive-pot-company-cronos-receives-sec-inquiry-2020-03-19>.

[7] <https://ir.thecronosgroup.com/news-releases/news-release-details/cronos-group-estate-certain-2019-unaudited-interim-financial>.

[8] *Id.*

[9] <https://www.sec.gov/litigation/litreleases/2018/lr24148.htm>;
<https://www.sec.gov/litigation/litreleases/2016/lr23479.htm>.

[10] https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_marijuana.