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COVID-19: Beware of the Danger; Prepare for the Opportunity

By Michael Napoli

"It's only when the tide goes out that you learn who has been swimming naked."

Commentators of various stripes have been repeating Warren Buffett's famous line in recent weeks to describe the economic dislocations occasioned by the coronavirus pandemic. Buffett meant that you cannot tell the true health of a company, an industry or a deal until adversity strikes. Bull markets hide flaws; bear markets expose them.

For federal equity receivers, Buffett's wisdom has a slightly different meaning. Economic turmoil and sudden market declines lead to the discovery of existing fraud and the commission of additional fraud.

The chart on the next page illustrates the relationship between market crashes and fraud.

The current crisis should be no different. Unemployment is at levels not seen since the Great Depression, oil prices turned negative at the end of April, and economic activity of most kinds has slowly stopped. Indeed, it may well be worse. We currently face not just a health crisis but social and economic crises as well. The pandemic has forced us to shelter in place with our immediate families, away from friends and extended family, afraid for our health, our livelihoods and our savings. Fear and isolation are breeding grounds for fraud.[1]

Two things should occur:

First, we can expect existing swindles to be revealed. Victims seeking liquidity will withdraw or attempt to withdraw funds from schemes placing financial pressure on fraudsters who will have difficultly recruiting sufficient replacement victims to keep their schemes operational. As a result, schemes fail, which attracts regulatory attention. This particular scenario has played out in each of the major market crashes over the last 30 years and probably since the first stock market, the Amsterdam Stock Exchange, opened in 1602.

Second, we can expect new swindles. Many investors, including the retired or those near retirement age, desperately

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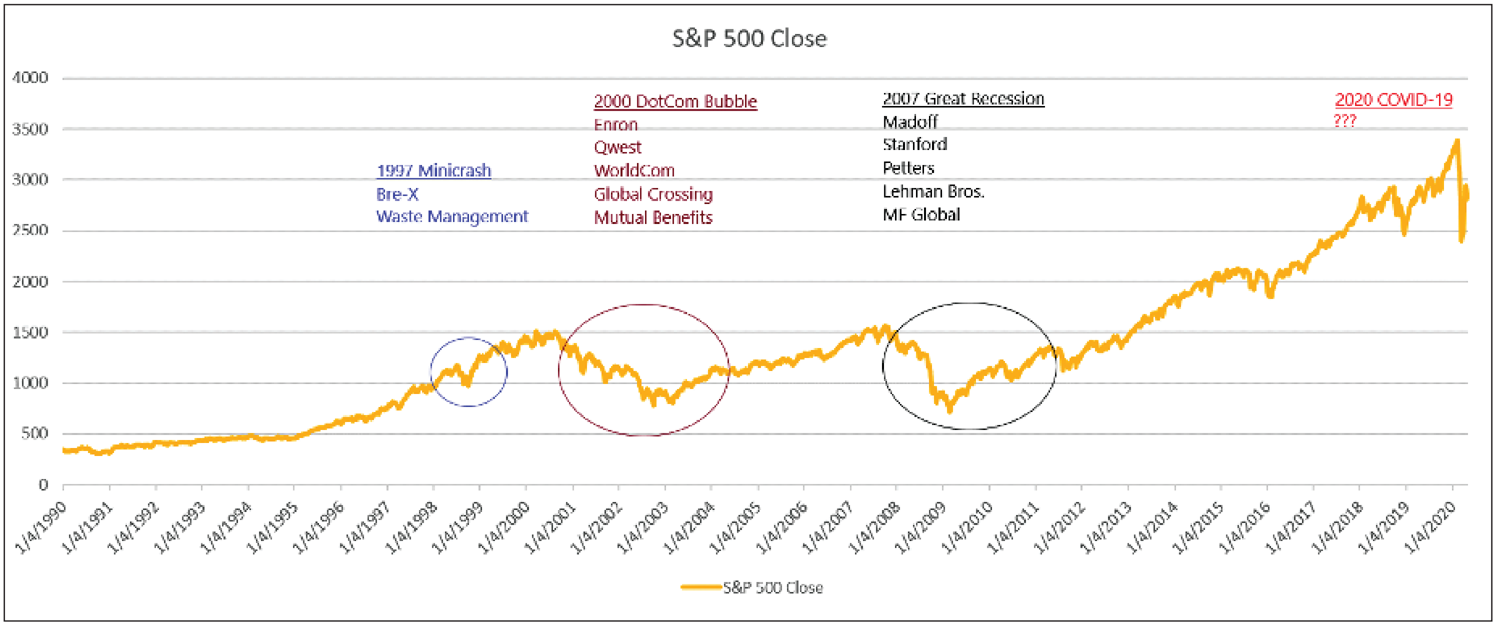

need income or growth that traditional investments can no longer provide. They have fled the market after seeing years of growth wiped out in a few weeks. Despite what they told their stockbrokers or themselves, many do not have the risk tolerance for equity investments. Moreover, the traditional alternatives—investment grade bonds, traditional CDs and other fixed income investments—are not good substitutes because of continuing low interest rates. These investors will be primed for opportunities that promise returns untethered from market or general economic risk. Others are simply greedy and looking to profit on other's misery.[2] Scammers have deals for them, too.

The regulatory community has been out in front of this trend. In addition to consumer scams such as fake coronavirus tests or medication and outright price gouging, regulators are warning of investment scams as well. For instance, the Texas State Securities Board ("TSSB") warned investors to "count on a flood of scurrilous investment offerings that claim to offer guaranteed returns to help you reclaim your financial footing. Some may be tied directly to the coronavirus. Most will probably be garden-variety, supposedly risk-free scams.[3]" The TSSB's action tracks ongoing alerts by the U.S. Securities and Exchange Commission ("SEC") and the U.S. Commodity Futures Trading Commission. Both federal agencies have warned of coronavirus-related and other investment scams. Likewise, the U.S. Department of Justice, the Consumer Financial Protection Bureau, and the Federal Trade Commission ("FTC") have all created coronavirus task forces to deal with these issues. State regulators, acting through the North American Securities Administrators Association ("NASAA"), have followed suit.

These regulators are serious, as demonstrated by the first spate of federal enforcement cases filed in quick succession in April 2020. This portends significant additional work for federal equity receivers and the professionals that support them. So how do we prepare for this work? What industries and asset classes should we be considering?

- **Health and prescription medication insurance:** Unemployment is at a 100-year high. As a result, many people no longer have access to employer-provided health insurance. Scams involving health insurance are an area of long-standing concern to the FTC.[4]

- **Medical supplies including personal protective equipment and ventilators:** The U.S. Department of Homeland Security reports that it is pursuing 370 cases of suspected fraud related to PPE.[5] The SEC recently filed an enforcement action arising out an issuer's false claim to have access to N95 masks.[6]

- **Virus tests, vaccines and cures:** Most of the regulatory actions to date were in the form of trading suspensions by the SEC.[7] We can expect, however, that suspensions will turn into enforcement actions, with most of the fraud occurring in private placement scenarios. NASAA and several state securities regulators have specifically warned about "blue sky" fraud involving tests and cures.[8] This type of fraud will likely outlive the pandemic because the global scientific focus has expanded to preventing the next pandemic.

- **Precious metals, gems, coins, stamps and other collectible items:** These so-called "alternative assets" are perennial favorites of the scam artist. As their value does not relate to the securities market and can be countercyclical, many investors perceive these assets as hedges against systemic risk.[9] In addition to standbys like coins and gold, we may also see fraud involving classic cars or art because investors perceive them to hold value in downturn markets. In the last year, several companies have begun offering fractional interests in classic cars to the public.[10] While there have been no reports of fraud in these offerings, the potential appears obvious.

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- **Currency trading including Forex and cyber currencies:** Currency trading continues to be a scammer favorite because success appears to stem from the ability to exploit technical changes in markets regardless of the overall trend in the market or health of the economy. TSSB shut down three such schemes in April alone.[11]
- **Oil and gas:** Scammers will promote investments in oil wells or working interests claiming that they can take advantage of the historic low energy prices and reap huge returns when energy markets recover.
- **Distressed debt and financial instruments:** Promoters claim to be able to identify and purchase "quality" promissory notes, bonds, leases or other financial instruments at distressed prices, thereby securing safe and outsized returns to investors.
- **Real estate:** As with energy assets and debt, scammers will claim to be able to "buy low, sell high" locking in guaranteed returns.

These are merely examples. Swindles come in all shapes and sizes and are limited only by creativity of the scammers.

The current crisis will likely lead to opportunities for many of us. It is up to us to make the most of these opportunities and to demonstrate (again) the value that experienced federal equity receivers can provide. We should proceed as we always do: compassionately, efficiently and effectively.

ENDNOTES

1 "Protecting seniors from fraud and financial abuse during COVID-19" (Canada Financial and Consumer Services Commission),https://fcnb.ca/en/guides/protecting-seniors-from-fraud-and-financial-abuse-during-covid-19.

2 "What most people don't seem to realize is that there is just as much money to be made out of the wreckage of a civilization as from the upbuilding of one…There's good money in empire building. But, there's more in empire wrecking." Margaret Mitchell, *Gone with the Wind* (quoting Rhett Butler).

3 TSSB Press Release, https://www.ssb.texas.gov/news-publications/investing-unknown (Mar. 23, 2020).

4 *E.g.*, *FTC v. Simple Health Plans, LLC*, No.: 18-CV-62593 (S.D. Fla.) (Oct. 31, 2018).

5 *Homeland Security Warns of Another Risk in Coronavirus Pandemic: Rampant Fraud* (Time May 12, 2020), https://time.com/5835547/coronavirus-fraud-scams/.

6 *SEC v. Praxsyn Corp.*, No. 20-cv-80706 (S.D. Fla.) (Apr. 28, 2020).

7 *See* https://www.sec.gov/sec-coronavirus-covid-19-response for a current list of suspensions; *see also* DOJ Press Release "Justice Department Files Its First Enforcement Action Against COVID-19 Fraud" (Mar. 22, 2020), https://www.justice.gov/opa/pr/justice-department-files-its-first-enforcement-action-against-covid-19-fraud.

8 North American Securities Administrators Association, "COVID-19-Related Investment Schemes Anticipated," https://www.nasaa.org/54534/covid-19-related-investment-schemes-anticipated/ (Mar. 30, 2020).

9 *Id.*

10 "Investing in shares of collector cars: Stupid or savvy?" https://www.hagerty.com/media/news/investing-shares-of-collector-cars-rally-road/ (Feb. 28, 2019)

11 TSSB Press Releases, COVID-19 News and Updates from State Securities Board: "Order: 'Profit Off Coronavirus' Investment Pitch Is Toxic" (Apr. 17, 2020); "Cryptocurrency Miner Features Fraudulent COVID-19 Charity Sales Pitch" (Apr. 8, 2020); "Forex Trader Touts 'Recession-Proof' Haven in Markets Roiled By COVID-19" (Apr. 3, 2020).