

Second Circuit Overturns Conviction of Institutional Trader But Upholds Government's Securities Fraud Theory

On December 8, 2015, the United States Court of Appeals for the Second Circuit reversed the convictions of a former bond trader at Jefferies & Company ("Jefferies") for fraud against the United States and making false statements, and the Court vacated convictions for securities fraud and remanded the case to the U.S. District Court for the District of Connecticut for further proceedings on those charges.¹ Jesse Litvak was successful in having his securities fraud convictions overturned on appeal based on certain evidentiary errors made by the district court, but he is expected to face retrial. Importantly, the Second Circuit's opinion validated the government's theory that the misrepresentations Mr. Litvak made to institutional clients regarding the price of bonds to disguise the amount of profit Jefferies made could be "material" under the securities laws. This decision is critically important as it suggests that downplaying the profit a financial institution is making on a particular client transaction or not being forthright about inventory can be material.

Background

The charges stem from Mr. Litvak's conduct trading residential mortgage-backed securities ("RMBS"), a type of asset-backed security whose value is derived from a pool of residential mortgages, in the wake of the financial crisis. At trial, the government alleged that between 2009 and 2011, Mr. Litvak made three types of misrepresentations to representatives of counterparties in relation to RMBS transactions. First, he misrepresented to purchasing counterparties Jefferies's acquisition costs of certain RMBS. Second, he misrepresented to selling counterparties the price at which Jefferies negotiated to resell certain RMBS. Third, he misrepresented to purchasing counterparties that Jefferies was functioning as an intermediary between the purchasing counterparty and an unnamed third-party seller when in fact Jefferies held the RMBS in inventory and no third-party seller existed.

The government alleged that Mr. Litvak made these misrepresentations to increase Jefferies's profit. For example, Mr. Litvak told a counterparty that Jefferies had purchased certain RMBS at a price of \$58.00, when Mr. Litvak knew that Jefferies had actually purchased the securities at \$57.50. Jefferies then sold the securities to the counterparty at \$58.00, implying that Jefferies would make no profit. But Jefferies stood to make approximately \$60,000. Critically, and not surprisingly, a representative of this counterparty (and of others for other transactions) testified at trial that the difference in price would have "mattered" and been "important" to him.

¹ *United States v. Litvak*, No. 14-2902, 2015 WL 8123714 (2d Cir. Dec. 8, 2015).

Mr. Litvak was convicted of four counts of making false statements, one count of fraud against the United States, and ten counts of securities fraud following a fourteen-day jury trial.² Mr. Litvak appealed the convictions on several grounds.

Securities Fraud Convictions

With respect to the convictions for securities fraud, the Second Circuit vacated and remanded for further proceedings. The Court rejected Mr. Litvak's argument that his misrepresentations were immaterial as a matter of law and vacated based on certain evidentiary errors made by the district court.

Mr. Litvak argued that misrepresentations he made to counterparties during negotiations for the sale of bonds were immaterial under the securities laws because they did not relate to the bonds' value (as opposed to their price). At the outset, it's important to note that a misrepresentation is material under the securities laws when there is "a substantial likelihood that a reasonable investor would find the . . . misrepresentation important in making an investment decision."³ Whether a misrepresentation is material is a "mixed question of law and fact" that is "well suited for jury determination."⁴ For the Second Circuit to find that Mr. Litvak's misrepresentations were immaterial as a matter of law—as he argued the Court should—the Court would have to find that his misrepresentations must have been "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance."⁵

The Second Circuit found that there was sufficient evidence for a rational jury to conclude that Mr. Litvak's misrepresentations were material. The Court explained that the testimony from representatives of certain counterparties that Mr. Litvak's misrepresentations were "important" to them and that their employers were injured by those misrepresentations was sufficient to conclude that the issue was appropriately left to the jury to decide.⁶

² The charges for fraud against the United States and making false statements, in particular, were rooted in the fact that some of the counterparties in the charged transactions were Public-Private Investment Funds ("PPIFs"), an investment vehicle established by the federal government and funded by a combination of private investors and public funds supplied through the U.S. Department of the Treasury ("Treasury"). On appeal, Mr. Litvak argued that there was insufficient evidence to establish that his statements were capable of influencing a decision of the Treasury under the applicable materiality standard in relation to these charges. The Second Circuit agreed, finding that while the Treasury was charged with overseeing the PPIFs, it was removed from investment *decisions*, which were left to the PPIF asset managers, and reversed the convictions for fraud against the United States and for making false statements.

³ *Litvak*, 2015 WL 8123714, at *9 (internal quotation marks omitted).

⁴ *Id.* (internal quotation marks omitted).

⁵ See *id.* (internal quotation marks omitted).

⁶ The Court also rejected Mr. Litvak's argument that the district court failed to instruct the jury that the securities laws required proof of intent to harm and concluded instead, consistent with prior case law, that intent to harm is "not a component of the scienter element of securities fraud" under the relevant laws. *Id.* at *11.

The Court went on, however, to consider Mr. Litvak's other arguments regarding the evidentiary rulings by the district court, in particular the exclusion as irrelevant of portions of the proposed testimony of Mr. Litvak's expert regarding the process by which investment managers select and evaluate assets. In particular, the district court excluded expert testimony that investment managers investing in products like RMBS consider traders like Mr. Litvak to be "biased" and "often misleading."⁷ The Second Circuit found that the proposed testimony was relevant and should not have been excluded, because the testimony would have been relevant to whether a reasonable investor would have relied on Mr. Litvak's representations or to have found them to be misleading. The Second Circuit found that the exclusion was not harmless error because the evidence went directly to the issue of materiality. In other words, the expert testimony would have been helpful to the jury in determining whether a reasonable investor would have given credence to Mr. Litvak's representations about the price at which Jefferies was able to acquire or sell the RMBS. The Second Circuit also held that other evidence—including evidence that supervisors at Jefferies, including Mr. Litvak's supervisors, regularly approved of conduct with which Mr. Litvak was charged—was also erroneously excluded as irrelevant because the evidence would have been relevant to whether Mr. Litvak held an honest belief that his conduct was not improper or unlawful.

On remand, Mr. Litvak will have the benefit of these evidentiary rulings when rebutting the government's evidence that his misrepresentations would have been important to a reasonable investor or to show that he acted in good faith.

Take Away

Although Mr. Litvak was successful in reversing certain convictions and vacating others, the Second Circuit upheld the essential theory of the government's case on the securities fraud charges—that Mr. Litvak's misrepresentations could be material.

To be clear, the Second Circuit's decision does not set a precise standard for materiality under the securities law, only that the evidence adduced at Mr. Litvak's trial was sufficient to put the question to a jury. The Court's ruling has potential implications across the equity and fixed income, currencies, and commodities markets. Sales practices that might have been considered legitimate or standard market conduct can be called into question when misrepresentations are made about the amount of profit a firm earns on a transaction, even where no misrepresentations are made about the value of the financial instrument itself.

As the Second Circuit recognized, materiality was "hotly contested at trial,"⁸ and some commentators have suggested that Mr. Litvak's conduct was consistent with negotiation strategies employed throughout the fixed-income markets and reflected the kind of biased, puffery a reasonable investor should have expected (and ignored) from a broker-dealer. Indeed, if Mr. Litvak faces a second trial, he will likely proffer expert testimony that these kinds of biased representations were typical in the market and asset managers would not take them seriously when making investment decisions.

⁷ *Id.* at *12.

⁸ *Id.* at *15.

Ultimately, however, the Second Circuit's rejection of Mr. Litvak's argument that his misrepresentations were immaterial as a matter of law weakens any defense that reasonable investors would have expected broker-dealers to behave this way.

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If you have any questions, please feel free to contact [Breon Peace](#) or [Jennifer Kennedy Park](#) in New York or any of your regular contacts at the firm. You may also contact our partners and counsel listed under "[White-Collar Defense, Securities and Enforcement and Internal Investigations](#)" located in the "Practices" section of our website at <http://www.clearygottlieb.com>.

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