Patterson Belknap Webb & Tyler LLP

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Second Circuit Reverses Conviction in Bond Market Misrepresentation Case, but Endorses Government Theory of Materiality

Today, the United States Court of Appeals for the Second Circuit reversed the conviction of Jesse C. Litvak, a securities broker and trader at Jefferies & Company. Litvak had been convicted of various counts of fraud as a result of misstatements he allegedly made to counterparties in connection with the sale of securities. This case has been the subject of significant attention in the securities industry and amongst practitioners in the white-collar bar, given the government's aggressive prosecution of misrepresentations that many believed were similar to those commonly made in the bond market, a principal-to-principal market in which purchasers are typically sophisticated market participants who would be unlikely to take a bond trader's sales pitch at face value. Though the reversal may suggest a repudiation of the government's aggressive stance in the *Litvak* case, the Court's decision actually strikes a compromise, holding that a rational jury could conclude that Litvak's misstatements were material to his counterparties and thereby constitute fraud, but further holding that the District Court improperly excluded evidence supporting Litvak's defense. The Court ruled that Litvak can be retried on the securities-fraud counts (but not the other counts), but the retrial will be one in which he will not be handcuffed by the now-reversed evidentiary rulings made by the District Court.

Litvak's alleged misrepresentations

The Court's opinion centered on a series of misrepresentations allegedly made by Litvak to counterparties in residential mortgage-backed securities ("RMBS") transactions in the secondary market. First, according to the government, Litvak misrepresented to counterparties looking to purchase RMBS Jefferies's "acquisition costs" of the relevant bonds—that is, the price at which Jefferies originally acquired them—by claiming that the prices were higher than they actually were. Second, Litvak misrepresented to counterparties from which Jefferies was purchasing RMBS the prices at which Jefferies had negotiated to *resell* those securities to third parties (i.e., telling the counterparties that the resale price was lower than it actually was). Third, Litvak falsely stated to purchasing counterparties that Jefferies was functioning as an intermediary between the purchaser and an unnamed third-party seller, when in fact Jefferies owned the RMBS, and no third-party seller existed. According to the Court, each type of misrepresentation could have led a counterparty to believe that a transaction resulted in less profit for Jefferies than it actually received.

The Second Circuit's ruling

False statements count: Reversed due to insufficient evidence

Judge Chester J. Straub, writing for the three-judge panel, first concluded that the government had set forth insufficient evidence for a rational jury to convict Litvak on the counts of fraud against the United States and of making false statements. These counts arose out of a unique aspect of these transactions: they were conducted in connection with a program in which the Department of the Treasury created financial vehicles known as Public-Private Investment Funds ("PPIFs") to purchase RMBS. The Court reversed Litvak's conviction on these counts because there was insufficient evidence to conclude that his misstatements were reasonably capable of influencing a decision by the Department of the Treasury. Although Litvak's misstatements may have "negatively impacted the Treasury's investments," the Court concluded that the government had not shown that Litvak's misstatements were capable of influencing a *decision* by the Treasury Department, because the PPIFs at issue had been deliberately structured in a manner that "kept the Treasury away from making buy and sell decisions."

Securities fraud counts: Government offered sufficient proof of materiality

The Court next turned to the materiality element of the securities-fraud charges against Litvak, and held that a rational jury could have concluded that Litvak's misrepresentations were material based primarily on testimony at trial from several of Litvak's counterparties. According to these counterparties, Litvak's misrepresentations were "important" to them in the course of the relevant transactions. In arguing otherwise, Litvak relied principally on *Feinman v. Dean Witter Reynolds, Inc.*, 84 F.3d 539 (2d Cir. 1996), in which a group of purchasers of securities brought suit against brokers with whom they dealt, alleging that the brokers charged transaction fees that far exceeded the cost of the items or services listed, and that the fees were actually hidden, fixed commissions disguised to circumvent rules prohibiting fixed rates. In *Feinman*, the Second Circuit affirmed a grant of summary judgment for the defendants, holding that "no reasonable investor would have considered it important when deciding whether to buy or sell stock that a transaction fee of a few dollars might exceed the broker's actual handling charges."

The *Litvak* Court concluded that *Feinman* was "readily distinguishable" from the current case, for three principal reasons: (1) the brokers in *Feinman*, unlike Litvak, did not mislead their customers as to what portion of the total transaction cost was going toward purchasing securities versus the cost of the broker's involvement; (2) the amounts "pocketed" by Litvak on behalf of Jefferies (as much as several hundred thousand dollars in some transactions) were substantially larger than the "dollar or two" per transaction at issue in *Feinman*; and (3) Litvak's conduct could not be remedied by "competition among the firms in the labeling and pricing of their services" because of the "opaque" nature of the RMBS market.

Securities fraud counts: Government offered sufficient proof of scienter

Next, the Court rejected Litvak's argument that the scienter element of securities fraud under Section 10(b) requires proof of "contemplated harm" (or "intent to harm"). In doing so, the Court relied on *United States v. Vilar*, 729 F.3d 62 (2d Cir. 2013), for the proposition that intent to harm is not an element of securities fraud. The Court drew a contrast to mail and wire fraud, which, the Court noted, require proof of "contemplated harm" or "intended harm" to a victim.

Securities fraud counts: Retrial required due to improper exclusion of expert testimony and good-faith evidence

The Court then turned to Litvak's arguments for reversal based on the District Court's exclusion of certain portions of his experts' proposed testimony. First, the Court agreed with Litvak that the District Court abused its discretion in excluding testimony from a business-school professor and compliance attorney, who would have testified about "the process investment managers use to evaluate a security, and the irrelevance of the broker-dealer's acquisition price to that process." This testimony, Litvak argued, would have been "directly probative" on the question of materiality. The Second Circuit agreed, concluding that such expert testimony should have been admitted for the purpose of educating the jury about the "highly-specialized" field of RMBS trading, which lacks an "efficient, transparent secondary market through which value can be determined objectively." Without this testimony, the Court held, there were "few ways in which Litvak could put forth evidence to rebut the alleged victims' testimony that Litvak's misstatements were important to them."

The Court further held that the District Court abused its discretion in excluding testimony from a legal and compliance expert and former general counsel of FINRA. This expert would have testified about the "arm's-length nature of the relationship between a broker-dealer and counterparty," which Litvak contended was relevant to explain that he was not acting as an agent for the counterparties (whatever the victims of the fraud may have mistakenly understood). The District Court excluded this evidence as irrelevant, but the appeals court concluded that this testimony may have been relevant on the issue of materiality because a reasonable investor might construe such statements as having great import if they came from the investor's *agent*.

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Finally, the Court held that the District Court abused its discretion in excluding evidence tending to show that, during the relevant time period, supervisors at Jefferies regularly approved of conduct identical to that with which Litvak was charged. This evidence, the Court concluded, could have supported Litvak's attempt to introduce reasonable doubt as to intent to defraud; that is, that he honestly believed that his conduct was not improper or unlawful. It was therefore relevant under the "low threshold" set forth by Federal Rule of Evidence 401.

Impact of the decision

The Court's decision will likely influence how prosecutors and defense attorneys approach cases involving allegations of fraud, especially in the fixed-income market, which ordinarily does not have a commission-based fee structure or an exchange-traded price for the financial instruments that are traded. First, in some circumstances, traders who misrepresent the facts of how a security is priced can be found to have made material misrepresentations and even be subject to criminal liability. Although traders in the fixed-income market may be accustomed to quoting an "all-in" price, any misstatement about how much of that price is driven by external market conditions as opposed to the trader's inclusion of margin may be subject to additional scrutiny as a result of this decision.

Second, the Court's attention to whether there exists robust competition among firms may mean that the question of whether a trader will be held accountable for a misstatement could turn, at least in part, on the level of transparency in the particular fixed-income market at issue. For example, if an instrument is widely traded and pricing information is readily available, then it may be more difficult for the government to establish materiality. If an instrument is thinly traded and the relevant market is opaque, materiality may be easier to prove.

Third, having found that the government established a viable materiality theory, the Court held that a defendant must be permitted to challenge materiality through expert testimony. The Court noted that perhaps only through expert testimony can a defendant successfully dispute materiality when the government presents testimony from select counterparties who claim to have made investment decisions based on the misrepresentations. Moreover, the Court recognized that expert testimony about the market and the reasonable expectations of market participants could tip the balance of a trial. In the *Litvak* case, the defense will get a second chance to contest materiality, but this time with the benefit of expert testimony.

Finally, with respect to client counseling and compliance, the best advice remains perhaps the most obvious: don't make false statements in connection with the sale of securities, regardless of whether one believes his or her counterparties should know that those statements are exaggerated or mere puffery. Rather than discouraging the government from bringing cases similar to *Litvak*, as many in the white-collar bar had hoped, the Court's qualified endorsement of the materiality theory of the *Litvak* prosecution could well mean that more indictments will be sought in the fixed-income market where traders stray or cross the line. In light of this reality, firms and their employees must be even more diligent in their brokering activity.

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