

White Collar Update: Second Circuit Grants Jefferies Bond Trader New Trial on Securities Fraud Counts, Reverses Others

December 10, 2015

On December 8, 2015, the U.S. Court of Appeals for the Second Circuit overturned the conviction of Jesse Litvak, a former Jefferies & Company (“Jefferies”) bond trader, for charges relating to misrepresentations he allegedly made in transactions involving residential mortgage-backed securities (“RMBS”).¹ Although Mr. Litvak may be retried for securities fraud, the court held that he will be allowed to use previously excluded expert testimony to argue that his misstatements were not material to his counterparties. The press has reported that Deirdre Daly, the U.S. Attorney for the District of Connecticut, confirmed that the Government will retry Mr. Litvak as part of its “ongoing efforts to investigate and prosecute fraud in the fixed-income markets.”² The Second Circuit also reversed Mr. Litvak’s conviction for charges of fraud against the United States and making false statements, for which he does not face retrial.

Factual Background

Over the course of a 14-day trial in February and March 2014, the Government presented evidence that Mr. Litvak lied to his counterparties when buying and selling RMBS in an effort to secretly increase Jefferies’s profits. He allegedly did so in three ways: First, in an effort to inflate a prospective bond buyer’s purchase price, Mr. Litvak misrepresented that Jefferies purchased the bond at a higher price than it actually had. Second, and conversely, Mr. Litvak would aim to deflate a prospective bond seller’s sale price by misrepresenting that Jefferies resold the bond at a lower price than it actually had. Third, Mr. Litvak would misrepresent to a prospective buyer that he was working as an intermediary for a third-party seller, when in fact no third-party seller existed as Jefferies already owned the bond. All these tactics, the Government argued, helped Jefferies increase its profit margin by widening the spread between the prices at which Jefferies bought and sold bonds.

A jury sitting in the District of Connecticut convicted Mr. Litvak of multiple counts of fraud against the United States, making false statements within the jurisdiction of the Government of the United States, and securities fraud. The district court sentenced him to 24 months’ imprisonment, three years’ supervised release, and a \$1.75 million fine. In October 2014, the Second Circuit ordered Mr. Litvak released on bail while awaiting appeal because he “raised a substantial question of law or fact likely to result in reversal.”³

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

² Liz Moyer, *Conviction of Former Jefferies Trader Is Overturned*, THE NEW YORK TIMES (Dec. 8, 2015).

³ Order, *United States v. Litvak*, No. 14-2902-cr (2d Cir. Oct. 3, 2014).

The Second Circuit's Decision

In Mr. Litvak's appeal to the Second Circuit, he argued principally that even assuming that he made misrepresentations to his counterparties, he could not be convicted of any crime—false statements, securities fraud, or defrauding the government—because his misstatements were not “material.”

The court rejected Mr. Litvak's argument as to the securities fraud counts, holding instead that a jury could reasonably find that Mr. Litvak's misrepresentations were important to his counterparties. The court reasoned that these misstatements were not “so obviously unimportant to a reasonable investor,” especially considering Mr. Litvak's counterparties' testimony at trial that his misstatements were important to them.⁴

The court nonetheless vacated the securities fraud convictions and remanded for a new trial on those counts because the district court improperly excluded certain expert testimony that was relevant to the jury's determination of materiality. In so doing, the Second Circuit substantiated certain arguments that Mr. Litvak may now make to the jury in order to argue that his misstatements were immaterial to his counterparties as a matter of fact. In particular, Mr. Litvak may present expert testimony explaining that:

- Participants in the RMBS market use rigorous valuation processes when pricing RMBS, thus discounting the importance of counterparty representations during the course of negotiations. The court found this expert testimony “highly probative” because RMBS pricing, compared to many other securities, is more complicated, more subjective, and often based on participants' valuation models rather than prices from prior transactions.
- Minor price variances do not matter to sophisticated investors, such as those investors transacting with Mr. Litvak.
- Because Mr. Litvak acted as a principal—and not as his counterparties' agent—when trading RMBS, a jury could conclude that his misstatements could not have been reasonably viewed as important considering the “distance” a principal relationship creates “between Litvak and a reasonable investor.”

The court also held that evidence of Mr. Litvak's good faith—namely, that Jefferies supervisors knew and approved of similar conduct by other Jefferies employees, was relevant to Mr. Litvak's argument that he lacked fraudulent intent and was therefore admissible. Thus, although Mr. Litvak must again go before a jury on the securities fraud charges (and only the securities fraud charges), he can now make these arguments to the jury.

Favorably to Mr. Litvak, the Second Circuit reversed his false statement and fraud against the United States convictions. These counts concerned misrepresentations Mr. Litvak made to Public-Private Investment Funds (“PPIFs”), which are financial vehicles formed by the government as part of the Troubled Asset Relief Program (“TARP”). Materiality as to these charges depends on proving that the misstatements were capable of influencing a decision of the Department of the Treasury, the agency that oversees PPIFs. But, as the evidence at trial established, the PPIFs that transacted with Mr. Litvak were purposefully structured to insulate Treasury from making any buy or sell decisions; indeed, the Government was unable to identify *any* decisions that the Department of the Treasury made regarding the relevant transactions. The court therefore reversed these convictions for insufficient evidence, providing the Government no opportunity to retry Mr. Litvak on these counts.

⁴ Order at 36-37, *United States v. Litvak*, No. 14-2902-cr (2d Cir. Dec. 8, 2015). The Second Circuit also rejected Mr. Litvak's argument that the scienter element of the securities fraud counts required proof of “contemplated harm.” *Id.* at 44.

Practical Impact of the *Litvak* Decision

Although the Second Circuit overturned Mr. Litvak's conviction, it gave Mr. Litvak (and potential future defendants) a mixed ruling on the securities fraud charges. Whether misstatements similar to Mr. Litvak's are "material" as required to bring a securities fraud charge is now definitively a question for the jury. And although the Second Circuit held that Mr. Litvak should not have been deprived of the opportunity to make certain arguments to the jury in his defense, the availability of these arguments to future defendants is not likely to dissuade the Government from pursuing similar actions. Indeed, during the course of Mr. Litvak's appeal, the DOJ and SEC have filed [criminal](#) and [civil](#) charges against other bond traders and are reportedly pressing forward with industry sweeps for similar conduct.

Nevertheless, the Second Circuit's extensive discussion about the relevance of Mr. Litvak's experts to the ultimate question of materiality signals that defendants may have compelling arguments that similar misrepresentations made in the course of RMBS transactions are not crimes. Although juries may disagree, the Second Circuit appears sympathetic to the argument that these misrepresentations are not necessarily material considering that RMBS valuation is subjective and complex; the counterparties are sophisticated; transactions are conducted at arm's length; and puffery is common.

The Second Circuit's ruling also makes it difficult for the Government to pursue fraud or false-statement charges premised on misrepresentations made to PPIFs. Unless the Government can prove that the PPIF counterparties are structured differently from those at issue in Mr. Litvak's case, it will be difficult for the Government to contend that a misrepresentation made during the course of an RMBS transaction had the reasonable capability of influencing a decision of the Treasury.

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