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CLIENT MEMORANDUM

Court of Appeals Declines to Find That Misrepresentations Made to Sophisticated Counterparties in the Course of Negotiations are Exempt From the Securities Fraud Statute

December 10, 2015

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On December 8, 2015, the United States Court of Appeals for the Second Circuit, in a much anticipated ruling, reversed the convictions of a former Jefferies & Co. bond trader, Jesse Litvak, for fraud against the United States and for making false statements. The Circuit also vacated Litvak's securities fraud convictions, remanding for a new trial based on evidentiary errors made by the district court. The central issue in the case related to misrepresentations Litvak made in the course of dealing with counterparties, and raises wider industry implications. Rather than endorse Litvak's defense that as a matter of law his statements were permissible, the decision preserved the viability of the Government's theory that Litvak's statements could be fraudulent. Although a setback for the Government, the narrow bases for its loss in *Litvak* will neither halt the broader, more aggressive enforcement trends targeting the financial sector nor foreclose similar prosecutions already in the pipeline.

Litvak's Misrepresentations to Counterparties

Litvak traded residential mortgage-backed securities, or RMBS, for Jefferies. Litvak's trading counterparties included certain Public-Private Investment Funds, or PPIFs, funds established by the United States Government and funded, in part, by the United States Treasury, but managed by private asset managers with expertise in the securities and bond markets.

At trial, it was undisputed that Litvak made misrepresentations to his counterparties, including PPIFs, when negotiating the sale of certain RMBS. The misrepresentations fell into three categories: (1) when Litvak wanted to sell a RMBS, he might lie to his counterparty about the price Jefferies had originally paid to purchase the RMBS; (2) where Jefferies had negotiated an agreement with a third party to resell certain RMBS, Litvak might lie to his counterparty about the resale price that Jefferies had negotiated; and (3) Litvak would also, at times, misrepresent Jefferies' relationship to the RMBS, claiming that Jefferies was acting as a middleman between the counterparty and an unnamed third party, when, in fact, Jefferies owned the RMBS itself.

Fraud Against the United States and Making False Statements Charges

Both the fraud against the United States charge and the making false statements charges required the Government to prove Litvak's misrepresentations were material to the U.S. Treasury Department, the Government entity that oversaw the PPIFs. The Second Circuit explained that even though Litvak's misrepresentations were "relevant" to the Treasury and that the Treasury was negatively "affected" by Litvak's misrepresentations (because the PPIFs, which were funded with Treasury monies, paid too much for certain RMBS), that evidence was insufficient to prove materiality.

The Second Circuit explained that the standard for assessing materiality in government fraud and false statement cases is whether the misrepresentation is capable of "influencing" the "decision of the decision-making body to which it was addressed." After reviewing the record, the Circuit concluded that Litvak's misrepresentations could not have influenced a decision of the Treasury, because it was undisputed that the Treasury did not have the authority to make investment decisions for the PPIFs. Similarly, the Government failed to present evidence of any *other* decision made by the Treasury that could have been influenced by Litvak's misrepresentations. Because the Government failed to prove the materiality of Litvak's misrepresentations, Litvak's convictions for fraud against the United States and making false statements were reversed.

Securities Fraud Charges

Litvak's primary argument was that his misrepresentations were immaterial as a matter of law because the securities fraud statute does not criminalize misrepresentations that "affect negotiations" but do not relate to the value or quality of the product being sold. Rejecting Litvak's argument (and his reliance on earlier Second Circuit precedent), the Circuit found that Litvak's misrepresentations could be material because his statements left his counterparties in the dark concerning the "unusually high cost of doing business with Jefferies" and unable to compare Jefferies' services with that of a different broker. Having rejected the argument that Litvak's statements were immaterial as a matter of law, the Second Circuit noted testimony from Litvak's counterparties that Litvak's misrepresentations *were* important to them in deciding whether to purchase RMBS. The Circuit concluded that a rational juror could have found that Litvak's statements were material misrepresentations and, accordingly, that the securities fraud convictions did not merit reversal.

The Circuit also rejected Litvak's assertions that the securities fraud conviction should be reversed because the Government failed to prove that Litvak contemplated some actual harm or injury to the counterparties. The Circuit confirmed that the Government is not required to prove "contemplated harm" in a securities fraud case.

Evidentiary Errors

Although the Second Circuit's decision suggests that Litvak's misrepresentations—which he characterized as garden-variety negotiating tactics, common to salesmen everywhere—are actionable misstatements under the securities fraud statutes, it nonetheless vacated his securities fraud convictions on the basis of several evidentiary errors made by the district court.

The Second Circuit criticized the district court for excluding testimony offered by Litvak's expert that sophisticated investment managers, like Jefferies' counterparties, complete their own valuation of the securities they are interested in and do not rely on statements made by brokers in the course of negotiations when deciding whether or not to purchase a security. The district court had excluded this testimony as irrelevant, but the Second Circuit disagreed, finding that it was directly relevant to the question of whether a reasonable investor would have found Litvak's misrepresentations important. The Circuit emphasized that the jury was likely unfamiliar with the complicated and esoteric world of RMBS trading, which operates differently from the ordinary securities market familiar to the average juror, and noted the importance to Litvak's defense of the sophisticated context in which he was acting. The Second Circuit concluded that the error was not harmless and vacated the securities fraud charges, for remand back to the district court.

The district court had also precluded Litvak from presenting expert testimony that he was negotiating at arm's-length with his counterparties and did not serve as their agent. This testimony was important because the Government had characterized Litvak as collecting a "commission," which suggested a relationship of trust between him and the counterparties. Litvak's expert would have informed the jury that Jefferies was not collecting a "commission" but rather was earning a profit, as would any other buyer or seller in an arm's-length transaction. The Second Circuit noted that without this testimony the jury may have misunderstood the nature of Litvak's relationship to the counterparties and would therefore have been unable to properly assess the importance of his misrepresentations to a reasonable investor in the RMBS marketplace.

The Second Circuit also found that the district court had erred by precluding Litvak from offering evidence that other employees at Jefferies had made the same type of misrepresentations as Litvak, with the full knowledge and approval of Jefferies' supervisors. Litvak had argued that evidence of the culture at Jeffries, where such negotiating tactics were commonplace, was probative of his lack of criminal intent. The Second Circuit agreed with Litvak, finding that the excluded evidence supported Litvak's theory that he did not realize his conduct was improper or unlawful and therefore should have gone to the jury.

Conclusion

Evidentiary rulings rarely serve as the basis for overturning criminal convictions and the Second Circuit's decision is therefore unusual. However, the fact that Litvak's convictions were overturned on a limited basis—for errors that can be corrected at a subsequent trial—is unlikely to deter prosecutors from bringing similar cases in the future. One pending prosecution concerns three Nomura bond traders for similar negotiating tactics. If the Second Circuit had embraced Litvak's arguments regarding materiality, that prosecution—and the broader enforcement trend that it represents—would have faced significant obstacles. In light of the bases upon which the Circuit reversed the *Litvak* jury verdict, both Litvak and the Nomura defendants will have to persuade a jury that their conduct was not criminal. Although a defeat for the Government, *Litvak* likely will not deter the increased pace of investigations and enforcement in the financial sector, nor impact the fundamental principle upon which the Litvak and Nomura prosecutions are based, namely, that lying to counterparties in the financial markets—no matter how sophisticated the players—carries with it significant risk of criminal liability.

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December 10, 2015