

CLIENT ALERT

Second Circuit Reverses RMBS Fraud Conviction: Highlights Distinction Between Agency and Principal Relationships

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On May 3, 2018, the Second Circuit again reversed the conviction of former Jefferies & Company (“Jefferies”) trader Jesse Litvak, following his second jury trial in the United States District Court for the District of Connecticut. Litvak was convicted on one count of securities fraud for making misrepresentations in the purchase and sale of residential mortgage-backed securities (“RMBS”), and acquitted on nine similar counts.¹ The government charged that when acting as a broker-dealer in principal-to-principal transactions, Litvak overstated to proposed counterparties the prices he had paid for bonds to increase the price paid by the counterparty and Jefferies’s profit on the transactions.²

The Second Circuit held that the district court erred in admitting testimony from a counterparty in which the counterparty expressed his subjective, erroneous belief that Litvak was an agent acting on his behalf.³ Where the transaction was at arms-length and it was undisputed that Litvak owed no fiduciary duties to the buyer, this evidence was found to be prejudicial and its admission required reversal.⁴ This opinion reinforces the added challenge the government faces when

¹ *United States v. Litvak*, No. 17-1464-cr (2d Cir. May 3, 2018).

² *Litvak*, slip op. at 11-12.

³ *Id.* at 3.

⁴ *Id.* at 28, 38.

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it tries to bring fraud cases based on alleged misrepresentations by traders in principal-to-principal transactions when no fiduciary duties are owed.

Background: Litvak's First Trial

In 2013, Litvak, a former trader at Jefferies was charged with securities fraud, fraud against the United States, and making a false statement in a matter within the jurisdiction of the U.S. government. The Indictment alleged that Litvak lied to his counterparties, six Public-Private Investment Funds (“PPIFs”) and at least 14 privately funded entities, about the price at which Jefferies had agreed to buy or sell bonds and invented nonexistent sellers with whom he pretended to negotiate on counterparties’ behalf when in fact Jefferies already held the bonds in its inventory.⁵ Through these statements, it was alleged, Litvak increased the profitability of the relevant trades.⁶ Litvak was convicted on all counts.⁷

The Second Circuit reversed Litvak’s convictions for fraud against the United States and false statements, and vacated the securities fraud charges, remanding for a new trial. The Court of Appeals found that the district court erroneously excluded Litvak’s proffered expert testimony refuting the materiality of his alleged misstatements.⁸ Litvak had sought to introduce evidence regarding how reasonable investment managers value RMBS—such as through the use of sophisticated computer-pricing models—and how the profit sought by the broker-dealer was so minor compared to the bond price that misstatements about profit were not material to a reasonable investor.⁹ Another expert was to testify about the arms-length nature of the broker-dealer/counterparty relationship, which the Second Circuit noted was relevant to materiality because if an agency relationship existed, a reasonable investor may place “great import” on Litvak’s statements, but if no such relationship existed, his statements may have been viewed as less important.¹⁰

Litvak's Second Trial

After a second trial, Litvak was acquitted of all but one count of securities fraud.¹¹ On that count, a representative from counterparty Invesco Ltd. testified, erroneously, that he believed Litvak was Invesco’s agent and that broker-dealers “serve as an agent in between buyers and sellers.”¹² The prosecution elicited this testimony notwithstanding the fact that the prosecutor had conceded that Litvak had never been Invesco’s agent and an agency relationship did not exist in these

⁵ *United States v. Litvak*, 30 F. Supp. 3d 143, 146 (D. Conn. 2014), *rev'd in part, vacated in part*, 808 F.3d 160 (2d Cir. 2015).

⁶ *Id.*

⁷ *Id.* at 147.

⁸ *United States v. Litvak*, 808 F.3d 160, 183-84 (2d Cir. 2015).

⁹ *Id.* at 183-85.

¹⁰ *Id.* at 187.

¹¹ *Litvak*, slip op. at 13.

¹² *Id.* at 16.

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transactions.¹³ In fact, Invesco's compliance personnel had informed the Invesco representative before the transaction that broker-dealers were not agents of bond buyers in these trades.¹⁴ Even though the government recognized in summation that Litvak was not Invesco's agent, it stated that the testimony showed how Litvak tried to establish a relationship of trust.¹⁵ The government argued on appeal that "whether and why victims trusted Litvak or believed his representations was probative as to what an objectively reasonable investor would have thought, and thus relevant to the disputed issue of materiality."¹⁶

The Second Circuit held that the district court abused its discretion in allowing this testimony because even if the testimony had relevance, it "had a high probability of confusing the jury by asking it to consider as relevant the perception of a counterparty representative that was entirely wrong" and the government's argument that a perceived relationship of trust showed materiality could have misled the jury.¹⁷ In reversing the conviction, the Court held that the agency testimony was evidently of great importance to the jury because Litvak was acquitted on all other counts of securities fraud, where there was no credible testimony about a perceived agency relationship.¹⁸

Conclusion

The importance of the distinction between an agency relationship where a fiduciary duty is owed, and a principal-to-principal relationship where it is not, cautions prosecutors not to try to blur this distinction. This decision underscores the greater challenge the government faces when seeking to prosecute those trading in a principal-to-principal marketplace because it will be harder to satisfy its burden of proving that an alleged false statement made by one principal to another would have been material to a reasonable investor. The law is "settled" that "those at either end of an arms-length transaction are acting only in their own self-interest."¹⁹ In the words of the Court of Appeals, if an agency relationship existed, "misstatements would have been more important to a reasonable investor while, if such a relationship was lacking, the misstatements would have been less so."²⁰ This decision clarifies that it will be more challenging to prove fraud in principal-to-principal trades where parties often view negotiations with counterparties with "skepticism."²¹

¹³ *Id.* at 26-28.

¹⁴ *Id.* at 16.

¹⁵ *Id.* at 16-17.

¹⁶ *Id.* at 29.

¹⁷ *Id.* at 30-31.

¹⁸ *Id.* at 34.

¹⁹ *Id.* at 32.

²⁰ *Id.* at 13.

²¹ See *id.* at 34-35 (citing testimony of counterparties on transactions for which Litvak was acquitted where the counterparty representatives testified to their views of principal-to-principal transactions).

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