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Takeaways From 2nd Circ. Reversal Of Litvak Conviction

By **Harry Sandick and Michael Schwartz** (May 4, 2018, 4:32 PM EDT)

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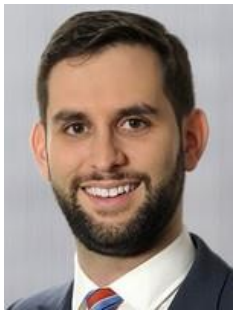

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On May 3, 2018, the U.S. Court of Appeals for the Second Circuit reversed the conviction of Jesse Litvak, who had been convicted in the District of Connecticut for a single count of securities fraud. Litvak's case has had a long and tortured history — indicted in January 2013, convicted at trial, conviction reversed on appeal, convicted at a retrial, and then imprisoned last fall after the court of appeals denied his application for bail pending appeal. The case raised significant questions about how traders should interact with their counterparties, and asked whether certain types of alleged misstatements made by traders rose to the level of criminal conduct. In the most recent decision by the circuit (Litvak II), the court had the option of ruling that the trader's alleged misstatements were not material as a matter of law — which could have made a dramatic impact in the law of securities fraud — but the court ruled for the government on this issue. Instead, the second appellate reversal did not turn on these larger questions about materiality and market practices, but rather was decided based on the erroneous admission of certain testimony relating to materiality. The court held that this error was not harmless, and remanded the case for possible retrial.

Background

Litvak was a securities broker at investment bank Jefferies & Co. In January 2013, the government indicted Litvak principally on 11 counts of securities fraud in connection with Litvak's purchase and sale of residential mortgage-backed securities. The government alleged that Litvak fraudulently misrepresented to counterparties the profits Jefferies was making on the purchase or resale of certain RMBS in order to increase his own profits.

In early 2014, a jury convicted Litvak of all counts except for one that had been dismissed before trial. Litvak appealed and, in December 2015, the Second Circuit vacated Litvak's conviction on the 10 remaining securities fraud counts.[1] The court held that the district court erred in excluding testimony from two defense experts regarding the "arms-length nature" of the relationship between Litvak and his counterparties. Litvak argued at his first trial that any misrepresentations as to the profits that he received were so minor compared to the sale price as to render those misrepresentations immaterial to a reasonable investor. In light of Litvak's argument, the court held that the excluded expert testimony might have been critical in supporting Litvak's defense that any misstatements were immaterial and thus inactionable.

The government retried Litvak on the 10 securities fraud counts in early 2017. Before trial, the district court denied Litvak's motion to exclude his counterparties from testifying that they believed Litvak was their agent rather than an arms-length counterparty. All involved agreed that as a matter of law, there was no agency relationship between Litvak and the counterparties. At trial, two counterparties testified that they thought Litvak had served as their agent in the relevant RMBS transaction. This time, the jury acquitted on all but one count, which involved a transaction with one of the testifying counterparties.

The Court's Decision

Litvak made two arguments on appeal. First, Litvak claimed that misrepresentations about the profits he received from the transaction were immaterial as a matter of law because his counterparty was interested only in the price of the bond, not the amount of Jefferies' profits. The court rejected this argument, holding that in this market "[t]he broker-dealer's profit is part of the price and lies about it can be found by a jury to significantly alter the total mix of information available." To prove materiality, the government called the purported victims as witnesses. These individuals were the counterparty traders who believed that they were misled by Litvak. This testimony was admissible so long as the government offered evidence of a "nexus between a particular trader's viewpoint" and that of the "mainstream thinking of investors in that market," which the government did here. The court held that counterparty testimony was evidence of materiality, that is, it was evidence that a reasonable investor would have deemed the misstatement a substantial factor to be considered in making a particular investment decision. By this standard, the jury was entitled to conclude that Litvak's misstatements were material.

Second, Litvak argued that the district court had improperly admitted the counterparty's testimony that he believed Litvak was acting as his agent. The court noted that it was undisputed that Litvak was not acting as an agent — indeed, while the government had sought to admit the testimony, by summation the government characterized the agency testimony as a "red herring" and described the counterparty as "confused" and "incorrect." Because the materiality standard is judged according to an objective, reasonable investor, the court held that the counterparty's "indisputably idiosyncratic and unreasonable viewpoint" was not "probative of the views of a reasonable, objective investor in the RMBS market." Put another way, the testimony improperly "equate[d] an indisputably incorrect personal belief with an objective test of materiality." In addition to being irrelevant, the testimony was more prejudicial than probative under Federal Rule of Evidence 403.

Next, the court concluded that the error was not harmless. The government's case on materiality "was not overwhelming and was vigorously contested," and the erroneously admitted testimony was proffered by the government, was of great importance to the verdict, and was not cumulative of properly admitted testimony. The third factor was especially crucial to the court's analysis. The court held that the "only rational reason for the jury" to have convicted on just that one count was the "perceived agency relationship" as to that transaction and the jury's consideration of "the subjective views of counterparty representatives."[2] The court vacated the conviction and remanded for further proceedings.

Commentary

There are several important takeaways from Litvak II. First, it is important to remember that the court did not accept the broader defense argument that misstatements about broker compensation (which is part of the broader all-in price) are insufficient to prove fraud as a matter of law. Before both Litvak I

and Litvak II, some observers asked whether the circuit's decision would mean that it is now legal to lie on Wall Street. The short answer is that it never was, and it isn't now. The decision makes it crystal clear that a defendant can be guilty even where the evidence shows that the purchaser was pricing the bond based on an internal analysis, or that the broker's statements about price were irrelevant to the "intrinsic value" of the bond. Traders who engage in puffery or exaggeration relating to price or margin do so at their own risk. The better course of action in light of Litvak II is for traders simply to state the price and not provide much further explanation.

Second, given the two reversals on appeal and a recent loss at trial in another case brought against a trader for similar misstatements in United States v. Demos, it may be that the government elects not to pursue similar cases in the near future. Even if the evidence was sufficient as a matter of law, Litvak's retrial resulted in acquittal on all but one count — and that one count was found to have been significantly influenced by evidence that should not have been admitted. It may be that even though jurors are told that reliance is not an element of the offense, they are reluctant to convict in a fraud case when the defendant's "victims" testify that he or she ordinarily viewed the statements of broker-dealers like Litvak with suspicion and skepticism, as people who "could be less than truthful." While the government may retry Litvak, it is hard to imagine a victory and also difficult to see how such continued prosecution is in the public interest. One wonders if this decision and the Demos acquittal will impact the government's decision to prosecute further the other bond traders who are currently facing charges in the same courthouse.

Third, the court's harmless-error analysis was somewhat more forgiving for this defendant than it has been in some other cases. The court closely assessed the evidence at trial and recognized that even though there was evidence of guilt, the testimony that should have been precluded may well have tipped the balance. One can imagine Litvak II being cited by defendants in other cases having nothing to do with securities fraud for its holding on harmless error.

Finally, it would have been interesting to have heard the court's deliberations about this case. When the court of appeals denied Litvak's application for bail pending appeal in August 2017, Litvak's chance of winning the appeal must have seemed remote, particularly since the court granted bail pending Litvak's prior appeal.[3] Without bail, Litvak has served almost nine months of his prison term. Then, when the appeal was argued on Dec. 11, 2017, the consensus was that Litvak's arguments were met with skepticism (although press reports did focus on Judge Ralph Winter's concern about the admission of the evidence that now has led to reversal).[4] At some point between Dec. 11, 2017, and the release of the decision, the court apparently determined that the conviction could not be sustained, and Litvak will soon be released on bail while the government decides its next move.

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[1] United States v. Litvak, 808 F.3d 160 (2d Cir. 2015).

[2] While a different counterparty provided similar testimony as to other transactions, the court observed that that counterparty's credibility had been severely weakened since he took several actions that suggested that he did not in fact believe Litvak was acting as his agent.

[3] Jody Godoy, "2nd Circ. Won't Give Litvak Interim Get-Out-Of-Jail Card," Law360 (Aug. 22, 2017).

[4] Jody Godoy, "Litvak's Appeal Argument Met With Skepticism In 2nd Circuit," Law360 (Dec. 11, 2017).