

May 7, 2018

## ***United States v. Litvak: Second Circuit Rejects Challenge to the Materiality of Misstatements but Overturns Conviction a Second Time Due to Agency-Relationship Testimony***

On May 3, 2018, for the second time, the Court of Appeals for the Second Circuit overturned the conviction of former Jefferies trader Jesse Litvak for alleged misstatements to an RMBS transaction counterparty.<sup>1</sup> The court vacated the conviction for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 on the basis that the district court prejudicially erred in permitting testimony by a counterparty trader that he believed that Mr. Litvak was acting as his “agent.” The Second Circuit remanded for a third trial.

In 2015, the Second Circuit had previously ordered that Mr. Litvak be acquitted on other charges and granted a retrial on the securities fraud counts.<sup>2</sup> In both appeals, the Second Circuit accepted the government’s once novel theory that misstatements that relate only to the negotiation process may be actionable as securities fraud, rejecting Mr. Litvak’s argument that his statements were immaterial as a matter of law. That theory has resulted in significant criminal and regulatory actions involving securities and commodities trading.

### **Background**

The defendant, Jesse Litvak, worked at Jefferies & Co., Inc. (now Jefferies LLC) as a trader in the secondary market for residential mortgage backed securities (“RMBS”). Secondary market trades in RMBS typically occur “over the counter,” in trades between brokers and sophisticated institutional investors.

The criminal case against Mr. Litvak began in January 2013, when the government alleged that, between 2009 and 2011, Mr. Litvak made fraudulent misrepresentations to multiple trade counterparties in order to reap excess profit from RMBS transactions. In particular, the indictment alleged that, in negotiations with counterparties, Mr. Litvak fraudulently misrepresented the cost to his firm of acquiring certain RMBS; the price at which the firm had negotiated to sell certain RMBS; and his function as an

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<sup>1</sup> *United States v. Litvak*, No. 17-1464-cr (2d Cir. May 3, 2018). The opinion was written by Judge Ralph K. Winter Jr. on behalf of a unanimous panel that included Judge Denny Chin and District Judge Edward R. Korman (E.D.N.Y.) sitting by designation.

<sup>2</sup> *United States v. Litvak*, 808 F.3d 160 (2d Cir. 2015) ([Paul Weiss client alert](#)).

intermediary between the purchasing counterparty and an unnamed third-party seller (when in fact his firm owned the RMBS and no third-party seller existed).

In March 2014, a jury in the United States District Court for the District of Connecticut convicted Mr. Litvak of ten counts of securities fraud, four counts of making false statements, and one count of fraud against the United States. The district court imposed a sentence of 24 months of imprisonment and a \$1.75 million fine.

Litvak appealed the convictions arising out of his first trial to the Second Circuit. In December 2015, the court reversed the false statements and fraud against the United States convictions on the ground that Mr. Litvak's statements to the managers of funds created pursuant to TARP were not material to a decision of the U.S. Treasury Department. The court rejected Mr. Litvak's materiality challenge to the securities fraud convictions, but ordered a new trial on those counts due to evidentiary issues. At the new trial, Mr. Litvak was permitted to present additional expert testimony about the nature of the secondary market for RMBS and the prevalence and accepted nature of such misstatements in that market.

Following a second trial, in January 2017, Mr. Litvak was acquitted on nine of the ten securities fraud counts, and convicted on the sole remaining count. The sole count of conviction related to a transaction with a trader at Invesco, who testified at both trials. That witness gave Mr. Litvak a bid of 79-24 for an RMBS bond on a bid list.<sup>3</sup> Mr. Litvak placed a lower bid with the seller, 79-16, which proved to be the winning bid. Invesco ultimately paid 79-30 (approximately \$23.6 million) for the bond. The government alleged that Mr. Litvak lied in a Bloomberg chat with the Invesco trader when he wrote: "I bid your level" and "will work for whatever you want big man." By bidding 79-16 instead of 79-24, Mr. Litvak increased Jefferies' profit by about \$73,000.

Although the government had conceded that Mr. Litvak was acting as a principal, not an agent, the district court permitted the Invesco trader to testify before the jury that *he believed* Mr. Litvak to be acting as Invesco's agent. The prosecutor's closing argument admitted that Mr. Litvak was not Invesco's agent, but argued that Mr. Litvak "chose to establish a relationship of trust." The district judge also instructed the jury that Mr. Litvak was not Invesco's agent.

Following his second conviction, Mr. Litvak was again sentenced to 24 months of imprisonment and fined \$2 million.

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<sup>3</sup> RMBS prices are generally communicated as a percentage of the current face value of the bond. Non-integer prices are expressed in "ticks" (1/32nd of one percent) rather than decimals. "79-24" means 79 and 24 ticks, or 79.75.

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**Discussion*****Mr. Litvak's Statements Were Not Immaterial as a Matter of Law***

As in the first appeal, the Second Circuit rejected Mr. Litvak's argument that his misstatements were immaterial as a matter of law. Reviewing the evidence in the light most favorable to the government, the court held that a rational jury could have found Mr. Litvak's allegedly misleading statements material beyond a reasonable doubt. Thus, the decision overturning Mr. Litvak's second conviction did not alter the court's prior holding from Litvak's first appeal that misstatements made in the course of RMBS negotiations may form the basis for liability.

The Second Circuit credited the testimony of Mr. Litvak's counterparties that his misstatements were an "important factor" in their investment decisions. Slip Op. at 20. While the court agreed that materiality could not be proven by the "mistaken beliefs of the worst informed trader in a market," it found that there was a sufficient "nexus" between the witnesses' viewpoints and "the mainstream thinking of investors in that market." *Id.*

The court rejected Mr. Litvak's argument that his statements could not be material because they related only to Jefferies' profits, not to the "intrinsic value" of the RMBS. *Id.* at 25. The court noted that Jefferies' profits were part of the price paid by the purchasers, and thus could have significantly altered a reasonable investor's view of the total mix of information. *Id.*

***Mr. Litvak Was Prejudiced by Testimony Concerning an Agency Relationship***

The Second Circuit went on to grant Mr. Litvak a new trial based on the district court's decision to allow the Invesco trader to testify about his belief that Mr. Litvak was Invesco's agent. The court held that the Invesco trader's belief—which was contradicted by material he had received from Invesco's own legal and compliance department—was "idiosyncratic and unreasonable" and thus not probative of materiality. *Id.* at 30. The testimony was also prejudicial, particularly when combined with the government's argument about a "relationship of trust." *Id.* at 31.

The Second Circuit further held that the error was not harmless. The court noted that the government's proof was "not overwhelming" and "vigorously contested," that the testimony was elicited by the government and noted in its summation, and that this testimony was the "only rational reason" for the split verdict. *Id.* at 33–34.

**Analysis**

Mr. Litvak was the first defendant charged in what became an industry-wide investigation into over-the-counter secondary-market trading. Since 2013, the same novel and contested theory first used against

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Mr. Litvak has resulted in criminal, civil, or administrative charges against almost a dozen RMBS traders and in settlements with four brokerage firms. By twice rejecting Mr. Litvak's materiality challenge, the Second Circuit has left the door open for the government to continue to pursue, as securities fraud, misstatements that relate to the negotiation process as opposed to the intrinsic value of an investment.

On the other hand, repeated appellate reversals and defense verdicts have presented risks to continued government enforcement proceedings in this area. On the same day that the Second Circuit ordered a third trial for Mr. Litvak, a Connecticut jury acquitted former Cantor Fitzgerald trader David Demos on similar charges.<sup>4</sup> And last June, another Connecticut jury reached a divided verdict as to three former Nomura traders, acquitting each defendant on at least some counts, while convicting only one defendant on a single count and failing to reach a verdict on other counts.<sup>5</sup> Whether, after these setbacks, the government will slow down in bringing these types of cases remains to be seen.

We will continue to monitor the landscape and report in subsequent client alerts as appropriate.

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<sup>4</sup> *United States v. Demos*, No. 16 Cr. 220 (D. Conn.).

<sup>5</sup> *United States v. Shapiro, Gramins, and Peters*, No. 15 Cr. 155 (D. Conn.).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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