December 9, 2015

United States v. Litvak: Second Circuit Overturns Conviction, Holds Defense Is Entitled to Put Forward Expert Evidence on Materiality

On December 8, 2015, the Second Circuit overturned the convictions of a securities trader for alleged misrepresentations made to certain RMBS transaction counterparties, some of which were investment vehicles established and funded by the United States government.[1] The court reversed the convictions for making false statements and for fraud against the United States on the basis that the evidence was insufficient to permit a rational jury to find that his misstatements were material to the Treasury. It also overturned and remanded for a new trial the trader's convictions for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (the "Act") and Rule 10b-5 on the basis that the District Court erred in excluding certain defense expert testimony, and that this error was not harmless.

This Second Circuit opinion is notable not only because it rejected Litvak's vigorous and closely watched challenge, on materiality grounds, to the government's theory of the securities fraud prosecution, but also because it acknowledged a defendant's right, in a securities case of this kind, to mount a defense through expert evidence on materiality. This kind of expert evidence is particularly significant in cases, like the *Litvak* case, involving private transactions where there is little or no evidence of public market behavior that would shed light on materiality.

Background

The defendant, Jesse Litvak, was a securities trader at a global securities broker-dealer and investment banking firm. The government alleged that between 2009 and 2011, Litvak made fraudulent misrepresentations to several trade counterparties in order to reap excess profit from transactions in residential-mortgage-backed securities ("RMBS"). In particular, the indictment of Litvak contended that in negotiations with counterparties to RMBS transactions, 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 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).

[1] *United States v. Litvak*, No. 14-2902-cr (2d Cir. Dec. 8, 2015.) The opinion was written by Judge Straub on behalf of a unanimous panel that also included Judges Parker and Carney.

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Some of the counterparties to which Litvak was alleged to have made misstatements were Public-Private Investment Funds ("PPIFs"). PPIFs are financial vehicles established by the federal government to purchase troubled assets from financial institutions using government funds. Litvak was charged with multiple counts of securities fraud and making false statements, and one count of fraud against the United States.

A jury in the United States District Court for the District of Connecticut convicted 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 sentenced him to 24 months of imprisonment and three years of supervised release, and fined him $1.75 million. Litvak appealed to the Second Circuit.

Second Circuit Decision[2]

Insufficient Evidence for Jury to Find Misstatements Material to Treasury

Litvak contended that the evidence adduced at trial provided an insufficient basis for the jury to conclude that his statements were material to the Department of Treasury, and thus that he should be acquitted on the claims of making false statements to, and defrauding, the United States. Op. at 3. The Second Circuit agreed and reversed the convictions on those counts. *Id.* at 17. The court concluded that, even viewing the evidence in the light most favorable to the government, there was "insufficient evidence for a rational jury to conclude that Litvak's misstatements were reasonably capable of influencing a *decision* of the *Treasury*." *Id.* at 25 (emphasis original). The court noted that, in fact, the evidence showed that the Treasury was simply a limited partner in the PPIFs and retained no authority to decide what RMBS to purchase or at what price to transact. *Id.* at 26.

Sufficient Evidence for Jury to Find Materiality under Section 10(b) of the Securities Exchange Act

With respect to the securities fraud charges, Litvak contended that his misstatements were immaterial to a reasonable investor. *Id.* at 3. The Second Circuit rejected this argument; it held that "a rational jury could have concluded that Litvak's misrepresentations were material." *Id.* at 35.

The court noted that the standard of review is "exceedingly deferential", and that the question of materiality is "well suited for jury determination." *Id.* at 36. The court reiterated the well-established materiality standard under Section 10(b) of the Act and Rule 10b-5; an alleged misrepresentation is material if there is "a substantial likelihood that a reasonable investor would find the … misrepresentation important in making an investment decision." *Id.* at 36 (citation omitted). In finding sufficient evidence

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[2] The Second Circuit addressed numerous issues in its lengthy opinion, and noted that there were still more issues it did not reach, in light of the reversal of the judgments of conviction. In this Alert, we address certain, but not all, of the court's holdings.

to support materiality, the court noted that the trial record included testimony from several representatives of Litvak's counterparties who testified that his misrepresentations were "important" to them in the course of the transactions at issue, and that they or their employers were injured by Litvak's alleged misrepresentations. *Id.* at 37.

In rejecting Litvak's materiality arguments, the court noted the "longstanding principle" that "[section] 10(b) should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes." *Id.* at 42. The court held that "[f]inding [s]ection 10(b) inapplicable here … would require an impermissibly technical and restrictive construction." *Id.* at 43. The court's materiality holding was apparently influenced by the unusual facts of Litvak's case, and in particular the fact that "the public interest [was] implicated by the involvement of the Treasury as a major investor in several of Litvak's counterparties in the transactions at issue." *Id.* The court cited the involvement of the public interest as a reason for applying Section 10(b) "flexibly." *Id.*

Defendant Was Entitled to Propound Expert Testimony Relevant to Materiality

Although the Second Circuit sustained the Section 10(b) convictions on materiality grounds, it reversed them based on what the court concluded were erroneous evidentiary rulings excluding defense evidence concerning materiality. In particular, the court held that the District Court exceeded its allowable discretion in excluding key portions of the testimony of one of Litvak's proposed expert witnesses, a finance professor with experience as a portfolio manager. *Id.* at 48, 51.

The expert witness's proposed testimony concerned how investment managers select and value debt securities such as RMBS, and his expert opinion that a sell-side bond trader's statements (such as Litvak's) would be considered within the industry as "biased" and "often misleading." *Id.* at 48. The District Court excluded, as irrelevant, the entirety of the proposed expert's testimony.

Litvak argued on appeal that this evidence was probative of whether his misstatements would have been material to a reasonable investor. The court agreed. It held that the witness's proposed testimony concerning investors' valuation processes for RMBS, and the likely impact on the purchase price of a broker's statements made to a counterparty during the course of negotiating an RMBS transaction, "would have been highly probative of materiality, the central issue in the case." *Id.* at 57. The court concluded: "With such testimony before it, a jury could reasonably have found that misrepresentations by a dealer as to the price paid for certain RMBS would be immaterial to a counterparty that relies not on a 'market' price or the price at which prior trades took place, but instead on its own sophisticated valuation methods and computer model." *Id.* at 60.

Importantly, the court in fact recognized that "there are few ways" in which Litvak *could* have countered the government's argument that a reasonable investor would have found Litvak's statements material. *Id.* at 60. Exclusion of the evidence put Litvak in the "untenable position" of being left only with the "victims"

of his conduct as sources of potential testimony on the issue, rather than being able to produce his own evidence. *Id.* at 61. The court held the error was not harmless because without the expert testimony, Litvak "was left with little opportunity to present his non-materiality defense." *Id.* at 63.

The court need not have addressed Litvak's additional arguments in support of reversal, because the issues it had already reached resulted in reversal on all counts. The court nevertheless proceeded to address several other district court exclusions of proffered defense expert evidence. Among them, the Second Circuit held that the district court erred in excluding another portion of the same expert witness's testimony, which concerned the importance of minor price variances to sophisticated investors, because it would have been relevant to the element of materiality. *Id.* at 66. Additionally, the Second Circuit held that the district court had erroneously precluded a second defense expert from testifying, in this instance about the arm's length nature of the relationship between a broker-dealer and counterparty. This proffered testimony, the court held, was relevant to materiality, as the jury might have expected a reasonable counterparty to be more skeptical of Litvak's statements had it understood that Litvak was not the counterparty's agent. *Id.* at 70-73.

Analysis

The court's securities law holdings in *Litvak* are relatively narrow, and broke little new ground. The court's application of the materiality standard was relatively broad, and in particular appeared to reject defenses akin to puffery that in other contexts it has held preclude liability as a matter of law. The court's application of the materiality standard, however, was apparently influenced by the fact that Litvak's alleged conduct implicated the public interest. That was so because the United States government was the ultimate alleged victim.

Perhaps the most notable feature of the opinion was the expansive approach that the court took to the relevance and admissibility of defense expert evidence on materiality. It is now clear that under Second Circuit law, defendants in criminal actions for securities fraud are entitled to proffer extensive evidence of market practices and understandings to inform a court's and jury's assessment of what information a reasonable investor would find important to the total mix of available information. Underscoring the emphasis the court placed on this holding was the court's reaching out to decide that certain exclusions of proffered expert testimony were in error, even though those holdings were not necessary to the result the court reached in reversing the convictions. In the future, this holding may be particularly significant in cases, like Litvak's, that involve RMBS (or other securities not traded on the public markets), in which courts or juries may be significantly aided by expert testimony explaining the behavior and understanding of market participants.

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