

Lessons From the Market Place: The Importance of Compliance

An effective program is a key corporate function of increasing importance. It can be a competitive advantage, creating a tone of excellence which permeates the firm's culture, products, services and customer relations. It can also substantially mitigate claims of wrongdoing by the Government and private litigants. Indeed, it should be the first line of defense in such instances.

Yet the contributions of a compliance program can be overlooked or the systems inadequately developed. When this happens, compliance can become an issue. This point is well illustrated by a series of recent cases brought by the U.S. Attorney's Office in Connecticut ("USAO") and the Securities and Exchange Commission ("SEC").

The cases

The cases involve traders from two large brokerage firms, Brokerage A and Brokerage B. All of the trades involved transactions in opaque markets involving either residential mortgage backed securities ("RMBS") or commercial mortgage back securities ("CMBS"). Trading in those markets is conducted by market professionals through individually negotiated transactions.

Each case was seemingly straight forward. The charges centered on claims that the house trader lied when negotiating either the purchase or sale of RMBS or CMBS to the counterparty. The statements were typically recorded and not disputed. The USAO and SEC charged the traders with fraud.

The first case was brought against a senior trader at Brokerage A, Jesse Litvak. *U.S. v. Litvak*, No. 13-cr-00019 (D. Conn. Filed Jan. 25, 2013). The victims were the U.S. Treasury trading through entities that were part of the TARP program and other sophisticated institutional investors. Following a trail at which a series of recorded false statements made by Mr. Litvak were presented, guilty verdicts were returned on all counts.

Related Capabilities

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The Second Circuit reversed the convictions in part, concluding that the district court incorrectly excluded proffered defense expert testimony. The proposed testimony focused on the manner in which counterparties trade in the RMBS markets.

At the retrial the Government called witnesses that included representatives of the counterparties involved in the RMBS transactions. Each witness testified that knowing the representations were false would have been important to them. In contrast, Mr. Litvak introduced expert testimony that focused on the structure of the market, the rigorous due diligence conducted by counterparties regarding pricing, the models used for pricing when entering into trades and the fact that the trader was not the agent of the counterparties. Based on all of these factors the expert told jurors that investors in these distressed markets were relatively insensitive to the prices paid because of the upside potential.

Jurors, who were instructed that the standard of materiality was that of a reasonable investor in the RMBS markets, acquitted Mr. Litvak on all counts except one. The court imposed a sentence of 24 months in prison and a fine of \$2 million – the same prison term as in the first case but with a larger fine. The case is on appeal.

Prior to the Litvak retrial the Connecticut USAO and the SEC brought actions against three traders at Brokerage B based on trading in the RMBS markets. *U.S. v. Shapiro*, No. 15-cr-00155 (D. Conn. Filed Sept. 3, 2015); *SEC v. Shapiro*, No. 15-cv-07045 (S.D.N.Y. Filed Sept. 8, 2015). The securities fraud charges against each of the three traders were substantially similar to those brought against Mr. Litvak. Each trader was alleged to have lied in negotiations with counterparties involved in RMBS securities transactions. As in *Litvak*, the misrepresentations were recorded.

At trial the *Shapiro* defendants essentially followed the approach used in *Litvak* except the evidence about trading in the RMBS market was developed through cross-examination of the Government's witnesses rather than an expert. The Government presented ten witnesses, primarily counterparties or employees of Brokerage B. During cross-examination the witnesses testified that they never thought the tactics used were illegal, although they may have been uncomfortable with the approach. The witnesses also testified that the tactics were well known and not concealed. Indeed, the firm's compliance department was familiar with the tactics and had never expressed any concern, bolstering the belief that the lies were simply part of the negotiations.

The jury verdict in *Shapiro* is similar to that in *Litvak* – largely a victory for the defense. One defendant, however, was found guilty on one count of conspiracy and the jury was unable to reach a verdict on three other counts. The case is in post trial motions.

Finally, as *Shapiro* was proceeding to trial, the SEC charged two additional traders from Brokerage B with securities fraud based on trading in the CMBS market. *SEC v. Im*, No. 17-cv-0313 (S.D.N.Y. Filed May 17, 2017). Again the charges claim that the traders lied during discussions with counterparties about the purchase or sale of the securities. Again the misrepresentations were recorded. One defendant has settled with the SEC; a second filed a motion to dismiss arguing essentially the same points presented by the defense in *Litvak* and *Shapiro*. The motion is in briefing.

Discussion

From a defense prospective, the two trials were largely successful. The defendants were acquitted on virtually every count despite largely uncontested evidence that each trader lied to firm clients. Yet neither jury completely accepted defenses built on the claim that the lies did not matter because of the nature of the market – stated differently, an “everybody goes it” defense.

Despite the appearance of success for the defense, some of the defendants are still paying a hefty price. Mr. Litvak is going to prison for two years and will pay a huge fine. At least one of the defendants in *Shapiro* may go to prison and there could be a retrial on the counts where the jury did not reach a verdict. Each brokerage house suffered the consequences of having the Government claim and prove its clients were at least in part defrauded.

No doubt each of the two firms had compliance departments. The testimony in *Shapiro* established that the compliance department knew about the trading tactics and failed to raise any concern. This accounts for the fact that brokerage firm witnesses testified that until *Litvak* they understood that the tactics were not illegal but could cost the firm business.

Effective compliance programs could have changed the results in these cases. Instilling a positive culture of doing the right thing despite the “wild west” type markets should have resulted in honest negotiations with clients and no USAO or SEC investigations and fraud charges. More importantly, effective compliance could have fostered a positive image for the firm, giving it a competitive advantage in a chaotic market place.