

Trading In Opaque Markets: The Need For Compliance

Individual responsibility and accountability became a critical issue in the wake of the great financial crisis. From Capitol Hill to the cross-streets of small-town America it frequently seemed that the question of the day was “who done it,” name them as a defendant. Prosecutors at the Department of Justice and regulators at agencies like the Securities and Exchange Commission responded with statements like the *Yates* memorandum, demanding that every individual involved be identified, and a series of prosecutions.

One group of cases focused on trading Residential Mortgaged Back Securities (RMBS) or similar instruments. In that group of prosecutions the DOJ and the regulators have been far from successful. Yet the cases continue. The recent dismissal with prejudice by the DOJ and then months later the SEC of the cases which started this series of actions presents significant questions about how these cases and others are vetted prior to charges being brought. See, e.g., *U.S. v. Litvak*, No. 13-CR-00019 (D. Conn. Filed Jan. 25, 2013); *SEC v. Litvak*, Civil Action No. 3:13-CV-00132 (D. Conn. Filed Jan. 28, 2013); see Lit. Rel. No. 24468 (December 6, 2018)(dismissals).

The cases

Litvak is one of a group of trading cases brought the DOJ and the SEC centered on opaque markets. Jesse Litvak was a trader and managing director at Jefferies & Company. The DOJ and SEC charges centered on the manner in which trading was conducted in the opaque market for RMBS. Specifically, Mr. Litvak was charged with repeatedly making misrepresentations regarding pricing, the source of the securities being sold and other material matters to effectuate a transaction for his firm at a time when revenues were declining.

The victims of the fraud were sophisticated funds and investors. They included DE Shaw, Magnetar, Putnam Investments and the U.S. Government. The indictment included 11 counts of securities fraud, one count of TARP fraud and four counts of

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making false statements based on transactions that took place over a two year period beginning in 2009. Jefferies made about \$2 million on the transactions. Following a 14 day jury trial Mr. Litvak was convicted on all counts submitted to the jury. He was sentenced to serve 24 months in prison followed by 3 years of supervised release and ordered to pay \$1.75 million.

The conviction of Mr. Litvak turned out to be just the first chapter. Subsequently, the Second Circuit Court of Appeals reversed his conviction while he was out on bond. First, the Court held that the counts regarding the Government must be reversed. The complex structure used to make decisions regarding purchases by the Government precluded whatever statements were made by Mr. Litvak from being considered. Second, the district court erred by excluding two experts offered as defense witnesses. Those witnesses would have testified that the markets were complex, opaque and inefficient. Perhaps more importantly, the professional traders that populated the market used complex systems and models to evaluate potential transactions which essentially made any statement by Mr. Litvak not relevant.

Retrial went better and worse for Mr. Litvak. The Government counts were excluded. The expert testimony was admitted. The jury found him not guilty on all counts except one. The district court essentially re-imposed the same sentence but increased the penalty to \$2 million. Release pending appeal was denied. Mr. Litvak went to prison.

The Second Circuit again stepped in, reversing the conviction. This time the Circuit Court concluded that the district court erred in admitting testimony by a representative of a counter party that all parties agreed was erroneous. *Litvak v. U.S.*, 889 F. 3d 56 (2nd Cir. 2018).

While Mr. Litvak battled the Government other, similar cases were brought. In September 2015, while Mr. Litvak's first appeal was pending, the U.S. Attorney's Office in Connecticut and the SEC essentially cloned the *Litvak* case into one charging three traders from Nomura Securities. *U.S. v. Shapiro*, No. 15-CR-00155 (D. Conn. Filed Sept. 3, 2015); *SEC v. Shapiro*, Civil Action No. 15-CV-07045 (S.D.N.Y. Filed Sept. 8, 2015). The charges were essentially the same, minus the Government counts. Supposedly the firm had illicit profits of about \$7 million.

Shortly after the reversal of Mr. Litvak's first conviction by the Second Circuit, *Shapiro* went to trial. The defense used the *Litvak* approach, based largely on testimony from traders. That testimony confirmed the opaque nature of the markets, the sophistication of the professional traders and the complexity of the models used to make investment decisions. Compliance understood the wild west tactics of the markets and made no effort to intervene, according to the testimony.

Following a multi-week trial and a week of deliberations, the jury returned verdicts of largely not guilty. One defendant was found guilty of conspiracy. The jury was unable to return a verdict on three counts. The case lurched into post-trial proceeds and has not been resolved. See also *SEC v. Im*, Civil Action No. 1:17-cv-0313 (S.D.N.Y. Filed May 17, 2017)(filed against two Nomura traders prior to the *Shapiro* verdict, one of whom

settled, based on trading in commercial mortgage backed securities or CMBS, a similar market; the case continues in litigation).

Comment

After years of litigation what at first blush must have appeared to be open and shut cases remain largely unresolved. Nobody denies that the traders in these markets make misstatements which in many instances in securities markets like the New York Stock Exchange, NASDAQ and others would be material. The markets in these cases are not anything like those exchanges however. The securities involved in these cases have little to no resemblance to shares of stock like Apple and Exxon.

It seems apparent that Government and regulatory investigators did not carefully assess the markets when making the charging decisions in *Litvak*, *Shapiro* and *Im*. Dropping the Government related charges following Mr. Litvak's first successful appeal more than supports the point.

Yet it is inexplicable that it took two trials, two appeals and a stint in prison before the charges were dropped against Mr. Litvak – and that the other cases are still in litigation. To be sure, nobody wants to see the kind of unsavory tactics employed in these markets continue let alone proliferate. The U.S. securities markets have long been viewed as the life blood of the world's largest economy. Those critical streams of commerce should not be polluted with misstatements and lies regardless of their impact. Every brokerage house, every fund, every CCO and every trader needs to understand that each statement made is their word and their bond representing them personally along with their firm in the nation's market place.

Whatever it was that sparked these cases – the intense pressure to charge individuals, a dislike for the tactics or something else – it is time these cases were brought to an end. Not every spat of improper or unsavory conduct is the stuff of which enforcement actions are made. There are other, much more effective ways to ensure the proper functioning of the securities markets. The DOJ and SEC need to use them now.