

Client Update

Two Decisions Highlight Significant Litigation Challenges for Prosecutors and Regulators

WASHINGTON, D.C.

Jonathan R. Tuttle
jrtuttle@debevoise.com

Robert B. Kaplan
rbkaplan@debevoise.com

Paul R. Berger
prberger@debevoise.com

Laura E. O'Neill
leoneill@debevoise.com

NEW YORK, N.Y.

Sean Hecker
shecker@debevoise.com

Bruce E. Yannett
beyannet@debevoise.com

Lee A. Schneider
lschneider@debevoise.com

The Securities & Exchange Commission (“SEC”) and the Department of Justice (“DOJ”) this month were handed losses in two high-profile appeals involving professionals in the fixed-income industry. On December 8, 2015, in *Flannery v. SEC* and *Hopkins v. SEC*, the First Circuit reversed an SEC Order that had fined two former State Street Global Advisors employees for allegedly providing misleading information regarding a bond fund during the 2007 subprime mortgage crisis.¹ On the same day, the Second Circuit issued a decision in *United States v. Litvak* that vacated former Jefferies Group trader Jesse Litvak’s criminal conviction in the District of Connecticut for securities fraud.² The opinions underscore evidentiary obstacles that the government faces in actions against individual defendants, particularly in proving materiality and scienter.

FLANNERY V. SEC AND HOPKINS V. SEC

The two First Circuit cases were originally brought in 2011 as an administrative proceeding against John “Sean” Flannery, former Chief Investment Officer for fixed income at State Street Global Advisors, and his colleague James Hopkins, a former vice president and head of product engineering, for allegedly failing to adequately disclose the exposures of a bond fund that was largely invested in subprime mortgage-backed securities. After an 11-day hearing, the SEC’s Chief Administrative Law Judge (“ALJ”) dismissed the proceeding, finding that “neither Flannery nor Hopkins was responsible for, or had ultimate authority over, the allegedly false and materially misleading documents,” and moreover that the documents did not contain any materially misleading statements or

¹ *John P. Flannery v. SEC* and *James D. Hopkins v. SEC*, Nos. 15-1080, 15-1117 (1st Cir. Dec. 8, 2015) (petitions reviewed jointly).

² *United States v. Litvak*, No. 14-2902-cr (2d Cir. Dec. 8, 2015).

omissions.³ A divided panel of SEC Commissioners subsequently conducted a *de novo* review and found the defendants liable for various fraud charges under Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder in connection with three communications to investors.⁴

In vacating the Commission Order, the First Circuit held that the Commission's findings did not meet the burden of demonstrating "substantial evidence" of culpability. The ruling emphasized that the Commission had not pointed to any actual investors who could testify to the materiality of a presentation that was at issue, had "failed to identify a single witness that supports a finding of materiality" as to statements in letters providing investment advice to clients and had not affirmatively shown that any one statement in the client letters was inaccurate.

In focusing on the Commission's lack of substantial evidence regarding the defendants' culpability, the court echoed the Chief ALJ's prior finding that neither Flannery nor Hopkins bore responsibility for alleged misstatements in certain of the documents. For statements that were made by the individuals, the court emphasized that materiality and scienter analyses are interrelated, concluding that the Commission's "thin materiality showing cannot support a finding of scienter." As the court noted, even if it were to accept that a slide prepared by Hopkins was misleading, it did not necessarily follow that the misstatement was material to investors, or that it met the evidentiary burden of demonstrating "highly unreasonable" actions necessary for a finding of recklessness under Section 17(a)(1), Section 10(b) and Rule 10b-5.

The Commission Order made headlines in 2014 for its effort to "resolve the ambiguities in the meaning of Rule 10b-5 and Section 17(a)" in the wake of the Supreme Court's opinion in *Janus Capital Group v. First Derivative Traders*,⁵ which held that an individual must have "ultimate authority" over a statement in order to "make" the statement for purposes of Rule 10b-5(b). The First Circuit, however, analyzed only whether the Commission had identified substantial evidence for its finding of a fraudulent course of business, and noted that it "d[id] not reach Flannery's argument that the Commission's interpretation of Section

³ *In the Matter of John P. Flannery*, Initial Decision Rel. No. 438, 2011 WL 5130058 (Oct. 28, 2011).

⁴ *In re John P. Flannery & James D. Hopkins*, Sec. Act Rel. No. 9689, 2014 WL 7145625 (Dec. 15, 2014).

⁵ 131 S. Ct. 2296 (2011).

17(a)(3) as applying to misstatements is incorrect.” The circumscribed opinion leaves unresolved the open questions surrounding the Commission’s reading of *Janus* as being inapplicable to violations of Section 17(a), Rule 10b-5(a) and Rule 10b-5(c).

UNITED STATES V. LITVAK

The same day that the *Flannery* decision came down in the First Circuit, the Second Circuit overturned the 2014 conviction of Jesse Litvak, a former fixed-income trader with Jefferies Group. Litvak had been charged with making misleading statements about residential mortgage-backed securities prices to purchasing counterparties in order to maximize Jefferies’ profit margin on the transactions.

As in the First Circuit opinion, the *Litvak* decision centered around the government’s materiality arguments. First, the Second Circuit reversed Litvak’s conviction for fraud against the United States, on the grounds that the evidence at trial was an insufficient basis for a rational jury to find that Litvak’s misstatements were material to the government under § 18 USC 1031 where the prosecution had not shown that the statements influenced any actual government decision.⁶ The court then vacated Litvak’s conviction as to ten counts of securities fraud, and remanded for a new trial on those charges, on the grounds that the District Court exceeded its discretion by excluding portions of testimony from the defense’s expert witness as to materiality.

In reaching these conclusions, the court noted particularly that the District Court had excluded expert testimony that investment managers typically conduct their own research to determine fundamental values of a security and tend to disregard statements of traders as relevant only to the “price” and not the “true value” of a bond. The court observed that “[t]he full context and circumstances in which RMBS are traded were undoubtedly relevant to the jury’s determination of materiality,” and held that without this relevant evidence, the jury could not properly weigh the evidence of importance to investors, since the testimony heard by the jury all came from alleged victims.

⁶ Because Litvak’s counterparties included Public-Private Investment Funds, the allegedly misled parties included participants in TARP’s Public-Private Investment Program, the U.S. Treasury and other investors. The court found that although the government established that the misstatements may have been relevant to the Treasury, the Treasury functioned as a limited partner in the PPIFs, and retained no authority to tell the investment managers which RMBS to purchase; the jury could not have inferred that any misstatements were capable of influencing a *decision* by the Treasury, when no evidence of any actual decision had been presented.

The court also held that the District Court exceeded its discretion in excluding testimony that Litvak's supervisors at Jefferies regularly approved of conduct that was identical to Litvak's actions. The Second Circuit viewed this evidence as relevant in determining whether Litvak "held an honest belief" that his actions were proper and lawful, disagreeing with the lower court's characterization of the evidence as merely "suggesting that everybody did it and therefore it isn't illegal."

The court did reject several of Litvak's other arguments, including that his misstatements were immaterial to a reasonable investor as a matter of law, finding instead that a jury could conclude that Litvak's representations could have prevented counterparties from meaningfully comparing Jefferies with its competitors in terms of transaction costs. The Second Circuit also held that the lower court was within its discretion to exclude testimony concerning the fair market value and profitability of the trades at issue, which were not elements of the charged offenses.

CONCLUSIONS

These significant rulings emphasize the government's heavy burden in proving market-based securities fraud offenses in both civil and criminal contexts. Regulators face particularly challenging obstacles in enforcement actions concerning specialized over-the-counter markets, which operate in a manner distinct from the more transparent equities market. As these rulings demonstrate, federal courts will continue to closely analyze the government's evidentiary showings of materiality and scienter, even, as in *Flannery*, where the Commission itself has found that the necessary burdens were met. The rulings further demonstrate that individual prosecutions—something both the DOJ and SEC have stressed as essential components of their enforcement agendas—will continue to be a double-edged sword for the government in light of the fact that individuals are more likely than companies or regulated entities to litigate and challenge aggressive enforcement theories.

* * *

Please do not hesitate to contact us with any questions.