Second Circuit's Rejection of Fraud Theory in LIBOR Manipulation Case May Have Far-Reaching Implications

Written by John W.R. Murray, Lynn Neils, Benjamin H. Weissman

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In a long-awaited decision on January 27, 2022, a unanimous panel of the U.S. Court of Appeals for the Second Circuit reversed the convictions of Deutsche Bank (DB) derivatives traders Matthew Connolly and Gavin Black in a fraud case arising from the alleged manipulation of the London Interbank Offered Rate (LIBOR). In *United States v. Connolly*,[1] the two traders were charged with pressuring the DB department responsible for submitting estimates of interest rates used to calculate LIBOR to benefit the bank's trading positions. After a jury trial, Connolly was convicted on two counts of wire fraud, Black was convicted on one count of wire fraud, and both were convicted on one count of conspiracy to commit wire fraud and bank fraud. In a striking rejection of the government's theory, the Second Circuit reversed those convictions and directed the district court to enter judgments of acquittal rather than simply to hold a new trial. With the Second Circuit's ruling, every conviction the government has obtained at trial in LIBOR manipulation cases has now been overturned.

Background

LIBOR is an interest rate benchmark meant to reflect, on a given day, the rates at which one bank can borrow cash from other banks. LIBOR is compiled by the British Bankers' Association (BBA) based on certain member banks' daily submission of a questionnaire, which at the relevant time reported an estimated "rate at which [each bank] could borrow funds." In large part as a result of scandals surrounding manipulation of LIBOR by traders at several leading banks, LIBOR is being phased out. Until recently, however, it has served as the most frequently used benchmark for short-term interest rates, and a wide range of financial products, including derivatives, bonds, and loans, have been pegged to LIBOR.

The instruments at issue in *Connolly* were interest rate swaps, under which one party paid a set rate of interest on a notional principal amount, while the other paid a floating rate linked to LIBOR. Depending on the size of the principal, a change of a few basis points up or down can mean billions in profits or losses on those swaps. Thus, a slight change in LIBOR for a certain day can have immense consequences for banks' trading positions.

At trial, the government relied principally on the testimony of three cooperators who worked in the DB unit responsible for submitting answers to the BBA questionnaire. They testified that they took into account requests from Connolly and Black to increase or decrease the rate they submitted to the BBA so as to increase the profits or decrease the losses from swaps made by the bank's derivatives traders. Moreover, the cooperators testified that they did so even though their LIBOR submissions to the BBA differed from the LIBOR rates reflected in the bank's internal "pricers," spreadsheets used to calculate rates at which DB's cash desk loaned funds internally to other bank units. They also testified that they knew that altering their LIBOR submissions was "wrong" because the bank was taking unfair advantage of the process. The government argued, and the district court agreed, that each day there was one "true" rate, reflected in the "pricer" that the bank should have submitted, and that the defendants' efforts caused the bank to submit a different rate based on the bank's trading positions. This, reasoned the district court, rendered DB's submissions false for purposes of the wire fraud statute (which the government acknowledged is interpreted identically to the bank fraud statute in the Second Circuit).

Second Circuit's Reversal

The Second Circuit disagreed, ruling instead that this evidence was insufficient as a matter of law to prove that Connolly and Black had caused Deutsche Bank to submit false statements to the BBA. The court's decision hinged upon the specific language in the BBA questionnaire. The questionnaire directed banks to submit the rate at which they "could" borrow money, which the accompanying instructions explained was meant to capture a hypothetical situation, rather than the rates at which a bank *actually* borrowed money. The BBA's instructions, the court noted, did not require (or even mention) the use of pricers and did not explicitly prohibit Deutsche from taking into account factors other than pricers, while the instructions *did* explicitly prohibit consideration of other banks' submissions. Thus, the bank's LIBOR submissions "did not implicitly represent that there had been no consideration of the panel bank's existing trades," and therefore, the submissions at issue were not false for purposes of the wire fraud statute. In so holding, the Second Circuit also relied on testimony from the cooperating witnesses that the rates they submitted were "rates at which [Deutsche Bank] could borrow funds," and thus complied with the letter of the BBA's instructions. The court also found significant that the cash desk routinely and subjectively considered other factors in determining its LIBOR submissions, such as rates from interbank cash brokers, so that there was in fact no single "true" rate.

In sum, "[t]he government failed to produce any evidence that any DB LIBOR submissions that were influenced by the bank's derivative traders were not rates at which DB could request, receive offers, and accept loans in DB's typical loan amounts; hence the government failed to show that any of the trader-influenced submissions were false, fraudulent, or misleading."

The court also stressed that the federal mail and wire fraud statutes "are not catch-all laws designed to punish all acts of wrongdoing or dishonorable practices." While the defendants' conduct may have been "wrong" and "may have violated any reasonable notion of fairness," the court reasoned, that did not make their statements to the BBA false under the wire fraud statute.

Implications of the Decision

The *Connolly* decision is not necessarily the final word from the Second Circuit; it remains to be seen whether the government will seek rehearing *en banc* by the full court. Assuming that the ruling stands, it is likely to further frustrate the government's attempts to use general fraud statutes to prosecute conduct in the financial markets that is arguably manipulative, unethical, or unfair unless it can also prove that the conduct involves a false or misleading representation or omission.

In particular, defendants can be expected to cite *Connolly* in market manipulation cases, in which the government charges (generally under the securities laws rather than general fraud statutes) that a trader bought or sold a security or commodity with the intent of sending a false signal to the market about supply or demand in order to move the market price. Indeed, on the heels of the Second Circuit's ruling, two former Deutsche traders challenged their convictions on charges of "spoofing," *i.e.*, placing trades they never intended to execute in order to benefit their positions on the other side of the precious metals market. Although no applicable rules specifically prohibited spoofing at the time, the government argued that their trades contained implied representations to the market that the trades were made in good faith, and their true intentions rendered those representations false. The defendants argue that there was no misrepresentation to the market because they had a good faith belief that their trades were permissible at the time, and that under *Connolly* their intent alone, however improper, cannot be the basis for a fraud charge.

We will continue to monitor how this all unfolds, including how other courts apply this decision, and whether defendants gain traction in extending the Second Circuit's reasoning beyond LIBOR manipulation to other financial fraud cases.

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[1] Nos. 19-3806-cr(L), 19-3944-cr(CON), 19-3945-cr(XAP), 19-3964-cr(XAP) (2d Cir. Jan. 27, 2022).

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