

ABA Committee on Regulation of Futures and Derivative Instruments

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Civil Litigation Developments

Developments in Civil Litigation Against Futures Commission Merchants

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Recent litigation against futures commission merchants (“FCMs”) has involved claims based on established theories of liability which have been reasserted on new facts. The good news for FCMs is that case law on the issues raised by these established theories has developed over the years, and has provided the FCMs with a legal basis for defending against these claims.

1. Alleged Liability of an FCM for Actions of a Customer

Customers of insolvent investment funds often have nowhere to recover for the fraud of the fund’s operators. The FCM which carried the fund’s account thus becomes a ready target for a claim that the FCM aided and abetted the operator’s fraud, and is therefore responsible for the losses caused by the fraud.

In *Amacker v. Renaissance Asset Management Fund, LLC*, 2008 U.S. Dist. LEXIS 82291 (S.D. Tex, 2008), the court dismissed a complaint by investors in a commodity pool against FCMs which acted as brokers for the pool’s accounts. The investors alleged that the FCMs were liable for losses on their investments in the pool on the ground that the FCMs aided and abetted violations of the Commodity Exchange Act (“CEA”) by the individual who operated the pool.

The allegation made in support of the claim of aiding and abetting was that the defendant FCMs failed to properly investigate the fund operator’s background. They argued that defendants had a duty under statutory and regulatory requirements to investigate the pool operator, that they failed to perform that duty, and that this failure to perform a duty constituted

aiding and abetting. Plaintiffs did not allege that the defendant FCMs knew that the pool operator was engaged in illegal conduct, but rather argued that the failure to investigate was reckless behavior, which was sufficient.

Relying primarily on *Damato v. Hermanson*, 153 F. 3d 464 (7th Cir. 1998) in which the Seventh Circuit had affirmed dismissal of a similar claim, the court in *Amacker* ruled that recklessness was not sufficient to support an aiding and abetting claim. Rather, the court held that the standard of intent for a civil aiding and abetting claim is the same standard that applies to a criminal aiding and abetting claim. This standard requires proof that the defendant: (1) had knowledge of the primary violator's intent to violate the CEA, (2) intended to further that violation, and (3) committed an act in furtherance of the violation. Because there was no allegation that the defendants knew of a violation by the pool operator, there could be no allegation of intent to further the violation and no act in furtherance of the violation.

The dismissal has been appealed to the U.S. Court of Appeals for the Fifth Circuit.

2. Alleged Liability of an FCM for Failure to Accept a Customer Order

In *Amaranth LLC v. J.P. Morgan Chase & Co.*, No. 603756/07 (N.Y. Sup. Ct. Nov. 10, 2008) the Supreme Court of New York dismissed all but one claim in a multiclaim complaint brought by Amaranth, LLC and Amaranth Advisors, LLC, a hedge fund and its affiliated advisory firm, against J.P. Morgan Futures Inc., the FCM where Amaranth maintained a futures account, and the FCM's affiliated banks. In the one claim that was asserted against the FCM, the complaint alleged that the FCM breached the customer agreement with Amaranth. Claims asserted against the FCM's affiliated banks were that they tortiously interfered with prospective economic advantage, violated the Connecticut Unfair Trade Practices Act, and were unjustly enriched by preventing Amaranth from transferring positions to other firms, and by entering into the transactions for their own benefit.

The complaint alleges that the fund, at a time when its natural gas derivatives had significantly declined in value, agreed to a trade with a third party (Goldman) whereby the third party would take over substantially all of the fund's natural gas book. The FCM allegedly refused to execute the trade. The fund then allegedly agreed upon a comparable trade with another third party (Citadel). According to the complaint, the FCM then made a false statement concerning the fund's solvency which prevented this trade from going through. The complaint alleges that the FCM's bank affiliates then inserted themselves between the fund and the third party, and that they received benefits of the trade which should have gone to the fund.

The court dismissed all claims except the breach of contract claim against the FCM. The breach of contract claim was based upon the alleged refusal of the FCM to execute trades ordered by the customer. The customer agreement included a provision requiring the FCM to execute orders that would have the effect of reducing the FCM's exposure to the customer. Amaranth had ordered J.P. Morgan Futures to execute trades that would transfer to Goldman the risk associated with Amaranth's gas derivatives portfolio, and contended that this trade would have reduced the exposure of the FCM to Amaranth.

The FCM responded that the trade would have required a release of margin funds to Goldman that would have increased the FCM's exposure to Amaranth. The FCM also relied on the provision in the customer agreement making transactions subject to exchange rules, and stated that the release of these margin funds, before the positions were transferred, would have violated NYMEX Rule 4.10(F), which prohibits release of margin funds that would bring an account below initial margin requirements.

The court declined to dismiss the breach of contract claim, based on the reasoning that there was a disputed fact whether the trade would have reduced the exposure of the FCM to the

customer. This decision, while based on the language of the contract, involves a contractual duty that is consistent with established case law regarding a broker's duty, which is that a broker has a duty to accept orders for liquidation, but is not required to accept orders which create new risks.

French v. Bache Halsey Stuart, Inc., Comm. Fut. L. Rep. (CCH) ¶20,444 (CFTC 1977).

3. Alleged Liability of FCM for Failure to Supervise an Account

In *Clifden Futures, LLC v. Man Financial, Inc.*, 20 Misc. 3d 638, 858 N.Y.S. 2d 580 (Sup. Ct. N.Y. 2008) the Supreme Court of New York dismissed a complaint brought by an FCM, Clifden, against another FCM, Man, for Man's alleged failure to supervise activity in the omnibus account which Clifden maintained with Man for the trades of Clifden's customers. Clifden alleged that Man breached its customer agreement and was negligent by allowing certain trading by one of Clifden's customers, which led to an uncollectible deficit in the customer's account with Clifden.

Clifden relied on the provision in the customer agreement which said that transactions were subject to the rules of the exchange. According to Clifden, these rules were thereby incorporated by reference in the customer agreement, and required Man to supervise the account. The court, however, ruled that the term "subject to" did not operate to incorporate the rules of the exchange into the contract, but rather was only a recognition that exchange rules governed transactions in the account. Therefore Clifden could not rely on violation of an exchange rule as basis for a contract claim..

The court also dismissed the negligence claim. The court ruled that even if the contract was breached, this did not support a negligence or other tort claim because a simple breach of contract is not a tort. Rather a tort must be based on a legal duty independent of the contract.

4. Alleged Liability of FCM for Failure to Enforce Exchange Rules

In *ADM Investor Services, Inc. v. Collins*, 515 F. 3d 753 (7th Cir. 2008), the Seventh Circuit affirmed a judgment in favor of an FCM for a deficit balance against the customer. The customer sought reversal on two grounds: (1) the introducing broker (“IB”) for the account had already paid the deficit to the FCM, so the customer should not have to pay it, and (2) the FCM violated exchange margin rules by accepting the orders which led to the deficit.

The Seventh Circuit rejected both arguments. The payment by the IB was subject to the collateral source doctrine, which meant that it was not a defense that the IB had paid the deficit. The court ruled that if the customer was required to pay the deficit, the FCM and IB could adjust their accounts accordingly. Collection of the deficit was also not precluded by violation of the margin rule, because the margin rules are to protect the FCM and not the customer. While the Seventh Circuit’s ruling on the purpose of margin requirements is consistent with established case law, the statement of the policy by the Court in this case is particularly well-reasoned and articulate, so that it is likely to be useful for quoting in future briefs and decisions where the issue arises.

The Future of Financial Services Patents

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Table of Contents

- I. Introduction..... 3
- II. Patentable Subject Matter 3
 - a. Statutory Subject Matter and its Exclusions 3
 - b. Supreme Court on Patentability 4
- III. State Street and Beyond 4
- IV. Comparing State Street with Foreign Jurisdictions 5
- V. Bilski at the Federal Circuit 6
- VI. Consequences of Bilski..... 7
- VII. Patently Obviousness 7
- VIII. Patent Activities in the Financial Services Sector..... 8
- Exhibit A. Excerpts of Federal Patent Statute..... 10
 - 35 U.S.C. 101 Inventions patentable. 10
 - 35 U.S.C. 102 Conditions for patentability; novelty and loss of right to patent..... 10
 - 35 U.S.C. 103 Conditions for patentability; non-obvious subject matter..... 11
- Exhibit B. Financial Patent Cases 13
 - I. Industry Focused..... 13
 - A. Patent Litigation – Historic Cases..... 13
 - B. Patent Litigation – Pending 13
 - II. Technology Focused 13
- Exhibit C. Recent Significant Patent Cases 14
 - I. U.S. Supreme Court..... 14
 - II. Federal Circuit..... 14
 - III. Foreign Jurisdictions..... 14
- Exhibit D. Bilski Patent Application 16

I. Introduction

Patents on financial services related inventions have become increasingly popular and controversial since court in the *State Street* case found Signature Financial's patent valid and infringed ten years ago. The financial industry responded to this case by dramatically increasing the number of patent applications they filed, overwhelming the U.S. Patent and Trademark Office (USPTO). This has been followed by a flood of patent litigations.

Recent developments at the Federal Circuit and the U.S. Supreme Court have counterbalanced the effect of *State Street*. The two development areas are: clarification on what is patentable (patentable subject matter) and changes to the analysis of whether an invention is obvious in light of the prior art (obviousness). Both of these areas of development will affect how the USPTO reviews patents applications and how the courts look at granted patents in the financial services industry. They should help move the financial services patents closer to an equilibrium point that is experienced in other industries.

II. Patentable Subject Matter

It is often stated that "anything under the sun that is made by man" is eligible for patenting. Quoting *Diamond v. Chakrabarty*, 447 U.S. 303 (1980). There are some notable exceptions and interpretations as to what is truly eligible for patenting.

a. Statutory Subject Matter and its Exclusions

The four statutory categories of invention defined in 35 USC 101, i.e. process, machine, manufacture, or composition of matter, have judicially created exceptions. See Appendix A. These exceptions are abstract ideas, laws of nature and natural phenomena. When applied to financial services related inventions, these exceptions are as difficult to quantify as are the four statutory categories of invention.

b. Supreme Court on Patentability

It has been some time since the Supreme Court addressed the issue of patent subject matter. The last time it took up this issue, it took three separate cases in less than a decade. The patentability trilogy cases are Gottschalk v. Benson, 409 U.S. 63 (1972); Parker v. Flook, 437 U.S. 584 (1978) and Diamond v. Diehr, 450 U.S. 175 (1981).

In 1972, the Court in Gottschalk held that a process claim directed to a numerical algorithm, as such, is not patentable because “the patent would wholly pre-empt the mathematical formula and in practical effect would be a patent on the algorithm itself.” Six years later, the Court in Flook found an invention that departed from the prior art in only the use of a mathematical algorithm is not eligible for patenting except in limited circumstances. The invention is only eligible for patenting if the implementation of the algorithm is novel and unobvious when the algorithm itself is considered part of the prior art.

Just three years after the Flook case, the Court held in the Diehr case that a computer program controlled process is patentable. The Court did not hold that the computer program itself was patentable but rather that a process that utilizes a computer program could be patented. This trilogy of cases formed the standard for patentable subject matter for years until they were joined by the State Street case.

III. State Street and Beyond

The case that brought business method patents to the forefront of people minds especially in the financial services industry is State Street Bank v. Signature Financial Group, 149 F.3d 1368 (Fed. Cir. 1998). This case held that a computer algorithm is eligible patentable subject matter if it produces “a useful, concrete and tangible result.” The State Street court focused on the “useful” limitation in 35 USC 101.

Since the claim in the State Street case involved the “transformation of data” it constituted a practical application of a mathematical algorithm, and thus it was patentable subject matter. The transformation of data is not a requirement “but merely one example of how a mathematical algorithm can bring about a useful application.” AT&T Corp. v. Excel Communications Inc., 172 F.3d 1352, 1358 (Fed. Cir. 1999).

The State Street and AT&T cases have been cited as “virtually abolishing subject matter limitations on the patent system”. eBay v. MercExchange, 547 U.S. 388 (2006). The Court stated that in these cases patent law had been transformed from “an exceptionalist regime tailored to technology to a generalist regime for all areas of human activity.” Shortly after the Supreme Court chided the Federal Circuit for these cases, the Federal Circuit abandoned the focus on the usefulness requirement in In re Comiskey, 499 F.3d 1365 (Fed. Cir. 2007) in favor of the physical steps requirement.

IV. Comparing State Street with Foreign Jurisdictions

In the U.S., business method inventions are not considered *per se* unpatentable as they are in some other jurisdiction. However, the shifting sands of patentability is not limited to the United States.

Under the European Patent Convention “[s]chemes, rules and methods for ... doing business” are not regarded as inventions and thus are not patentable. However, if the invention addresses a new method for solving a technical problem (i.e. it has a “technical effect”) it may be patentable. India follows a similar regime for business methods inventions. Canada follows the UK structure and prohibits “anything which consists of ... a scheme, rule or method for performing a mental act, playing a game or doing business, or a program for a computer.” Japan is one of the few jurisdictions that recognizes business methods outright.

A reading of the statutes and case law in the various jurisdictions does not result in a clear answer to what is eligible for patenting. For example, Section 1(2) of the 1977 Patent Act (the U.K. patent law) states that:

“the following . . . are not inventions for the purposes of this Act, that is to say, anything which consists of . . . (c) . . . a program for a computer . . . but the foregoing provision shall prevent anything from being treated as an invention for the purposes of this Act only to the extent that a patent or application for a patent relates to that thing as such.”

The UK Patent Office has stated that business method patents and computer programs are not patentable. However, this year, a U.K. court held that a software patent that improves the speed and reliability of a computer is patentable. Symbian Ltd. v. Comptroller General of Patents, EWCA Civ. 1066, (Court of Appeal of England and Wales 2008). Even in jurisdictions that state that business method patents are not available, patents are granted on business related inventions including financial service related inventions.

V. Bilski at the Federal Circuit

The case In Re Bilski is perhaps the perfect follow on case to State Street. The patent in State Street related to a “Data Processing System for Hub and Spoke Financial Services Configuration” and the claims in the Bilski patent application addressed a “method for managing the consumption risk costs of a commodity sold by a commodity provider at a fixed price.” See Appendix D. Bilski’s patent application was drafted in a broad format with no reference to the system that it would implemented on.

The court held that the Bilski method of hedging risks in commodities trading did not pass the patentable subject matter requirements. It stated that a process must 1. be tied to a particular machine or apparatus, or 2. transform an article into another state or thing.

A process cannot claim a fundamental principle but “an application of a law of nature or mathematical formula may well be deserving of a patent.” A claim that would have the

effect of pre-empting the use of a fundamental principle is thus not patentable subject matter.

In this analysis, the Federal Circuit rejected simply application of “useful, concrete and tangible result” test articulated in the State Street case. It also discarded the Freeman-Walter-Abele two-step “algorithm” test.

The Bilski case was taken directly *en banc* rather than being first heard by a three judge panel. The 9 to 3 ruling is widely thought to be headed to the U.S. Supreme Court. While the *en banc* panel was careful to structure its opinion around Supreme Court precedent, that is no guarantee against the Supreme Court’s continuing its activism in the area of patent law.

VI. Consequences of Bilski

The obvious consequence of the Bilski decision is that the USPTO will apply the higher standard to reject patent applications. The USPTO’s attempt to apply a “technical art” requirement was reject but the Bilski decision opened the door for the USPTO to reject many of the same type of claims under the new “machine or transformation test.”

For existing patents, the Bilski decision provides defendants and potential licensees with a new weapon to challenge the validity of any business method patent. For example, Bank of America is seeking to reopen discovery in the Every Penny Counts case based on the decision in Bilski.

VII. Patently Obviousness

When the U.S. Supreme Court took a patent that focused on the question of obviousness in 2007, many believed that the Court would judicially limit the scope of business method patents. The Court held in KSR International Co. v. Teleflex Inc. 127 S. Ct. 1727 (2007) that the Graham obviousness analysis is still the correct process. Further, it held

that the teaching-suggestion-motivation test (“TSM test”) can be a useful tool in applying the Graham analysis but it should not be applied too rigorously nor is it the only way to apply the Graham analysis.

The Graham analysis, as articulated in the Manual of Patent Examining Procedures, consists of considering “(1) the scope and content of the prior art, (2) the differences between the claimed invention and the prior art, (3) the level of ordinary skill in the pertinent art, and (4) objective evidence relevant to the issue of obviousness.” It is generally viewed that the KSR case made it easier to invalidate a patent based on obviousness.

Several cases have applied the KSR standard of obviousness. In Leapfrog Enterprises Inc. v. Fisher-Price Inc., 485 F.3d 1157 (Fed. Cir. 2007), the court found that the “method of operation” is not relevant to the Graham analysis for obviousness. It opened the door for the use of common sense in determining obviousness.

Recently, the Federal Circuit reversed a district court judgment of \$84 million finding the patent to be obvious. Muniauction Inc. v. Thomson Corp., 532 F.3d 1318 (Fed. Cir. 2008). The court applied an “obvious to try” standard to Muniauction’s patent. It stated that this approach was appropriate where “there is a design need or market pressure to solve a problem and there are a finite number of identified, predictable solutions.”

VIII. Patent Activities in the Financial Services Sector

Financial services related patents faced heightened scrutiny under patent subject matter and obviousness requirements. This is far from the end of patents in our industry. First, careful drafting of patent applications can avoid some of the concerns with patentable

subject matter. Second, many inventions in the financial services industry are more computer technology-based rather than financial services or business method.

An interesting example of a computer technology-based patent impacting on the financial services industry U.S. Patent Number 5,412,730 is entitled “Encrypted Data Transmission System Employing Means For Randomly Altering The Encryption Keys.” TQP Development LLC v. Merrill Lynch & Co. Inc. et al., case no. 08-cv-00471 (E.D. Tex). The patent at issue relates to secure communication method that uses encryption key values that may be changed frequently to reduce the likelihood of unauthorized access to data. A transmitting station sends new key values at intervals to a receiving station.

Other named defendants in the TQP case include: Bank of America Corp., Citigroup Inc., Goldman Sachs & Co., Morgan Stanley, the Royal Bank of Scotland Group PLC and TD Ameritrade Inc.

This case follows a series of patent cases that have plagued the retail banks for several years regarding a method for imaging and managing paper checks. U.S. Patent Nos. 5,910,988 and 6,032,137 (“the Ballard patents”) have not been fully adjudicated but rather have resulted in many significant settlements. These settlements include Affiliated Computer Services, Bank of New York Co. Inc., City National Corp., Compass Bancshares Inc., Groupe Ingenico, Harris Bancorp Inc., JPMorgan Chase & Co., NCR Corp., PNC Bank NA, and RDM Corp.

Patents will continue to play an important role in the financial services industry. However, companies will have to carefully consider each invention in light of the new standards when filing patent applications, seeking licenses or litigating.

Exhibit A. Excerpts of Federal Patent Statute

35 U.S.C. 101 Inventions patentable.

Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.

35 U.S.C. 102 Conditions for patentability; novelty and loss of right to patent.

A person shall be entitled to a patent unless -

- (a) the invention was known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant for patent, or
- (b) the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country, more than one year prior to the date of the application for patent in the United States, or
- (c) he has abandoned the invention, or
- (d) the invention was first patented or caused to be patented, or was the subject of an inventor's certificate, by the applicant or his legal representatives or assigns in a foreign country prior to the date of the application for patent in this country on an application for patent or inventor's certificate filed more than twelve months before the filing of the application in the United States, or
- (e) the invention was described in - (1) an application for patent, published under section 122(b), by another filed in the United States before the invention by the applicant for patent or (2) a patent granted on an application for patent by another filed in the United States before the invention by the applicant for patent, except that an international application filed under the treaty defined in section 351(a) shall have the effects for the purposes of this subsection of an application filed in the United States only if the international application designated the United States and was published under Article 21(2) of such treaty in the English language; or
- (f) he did not himself invent the subject matter sought to be patented, or
- (g) (g)(1) during the course of an interference conducted under section 135 or section 291, another inventor involved therein establishes, to the extent permitted in section 104, that before such person's invention thereof the invention was made by such other inventor and not abandoned, suppressed, or concealed, or (2) before such person's invention thereof, the invention was made in this country by another inventor who had not abandoned, suppressed, or concealed it. In determining priority of invention under this subsection, there shall be considered not only the respective dates of conception and reduction to practice of the invention, but also the reasonable diligence of one who was first to conceive and last to reduce to practice, from a time prior to conception by the other.

35 U.S.C. 103 Conditions for patentability; non-obvious subject matter.

(a) A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains. Patentability shall not be negated by the manner in which the invention was made.

(b)

(1) Notwithstanding subsection (a), and upon timely election by the applicant for patent to proceed under this subsection, a biotechnological process using or resulting in a composition of matter that is novel under section 102 and nonobvious under subsection (a) of this section shall be considered nonobvious if-

(A) claims to the process and the composition of matter are contained in either the same application for patent or in separate applications having the same effective filing date; and

(B) the composition of matter, and the process at the time it was invented, were owned by the same person or subject to an obligation of assignment to the same person.

(2) A patent issued on a process under paragraph (1)-

(A) shall also contain the claims to the composition of matter used in or made by that process, or

(B) shall, if such composition of matter is claimed in another patent, be set to expire on the same date as such other patent, notwithstanding section 154.

(3) For purposes of paragraph (1), the term “biotechnological process” means-

(A) a process of genetically altering or otherwise inducing a single- or multi-celled organism to-

(i) express an exogenous nucleotide sequence,

(ii) inhibit, eliminate, augment, or alter expression of an endogenous nucleotide sequence, or

(iii) express a specific physiological characteristic not naturally associated with said organism;

(B) cell fusion procedures yielding a cell line that expresses a specific protein, such as a monoclonal antibody; and

(C) a method of using a product produced by a process defined by subparagraph (A) or (B), or a combination of subparagraphs (A) and (B).

(c)

(1) Subject matter developed by another person, which qualifies as prior art only under one or more of subsections (e), (f), and (g) of section 102 of this title, shall not preclude patentability under this section where the subject matter and the claimed invention were, at the time the claimed invention was made, owned by the same person or subject to an obligation of assignment to the same person.

(2) For purposes of this subsection, subject matter developed by another person and a claimed invention shall be deemed to have been owned by the same person or subject to an obligation of assignment to the same person if -

(A) the claimed invention was made by or on behalf of parties to a joint research agreement that was in effect on or before the date the claimed invention was made;

(B) the claimed invention was made as a result of activities undertaken within the scope of the joint research agreement; and

(C) the application for patent for the claimed invention discloses or is amended to disclose the names of the parties to the joint research agreement.

(3) For purposes of paragraph (2), the term “joint research agreement” means a written contract, grant, or cooperative agreement entered into by two or more persons or entities for the performance of experimental, developmental, or research work in the field of the claimed invention.

Exhibit B. Financial Patent Cases

I. Industry Focused

A. Patent Litigation – Historic Cases

1. MuniAuction v. Thomson Financial and i-Deal – Reversed \$38.5 million damages doubled to \$77 million due to willful infringement. Muniauction Inc. v. Thomson Corp., 532 F.3d 1318 (Fed. Cir. 2008)
2. Edge Capture v. Citadel – Settled.
3. eSpeed and ETS v. NYMEX (WD Texas) Wagner patent litigation settled.
4. eSpeed and ETS v. CBOT and CME (WD Texas) Wagner patent litigation settled.
5. American Stock Exchange v. MOPEX, (SDNY 2003) Managed ETF patent held invalid.
6. Reuters Transaction Services Limited v. Bloomberg L.P. Settled
7. LiquidNet Inc v. ITG – Dismissed.
8. John Wald and Pendelton Trading System v. Investment Technology Group – Dismissed.
9. Garber v CME, CBOT, CBOE, and One Chicago - Dismissed.
10. EBS Dealing Resources v. Intercontinental Exchange – Dismissed.
11. Minton v. NASD – Patent invalid.
12. eSpeed Inc. v. BrokerTec – Patent invalid.

B. Patent Litigation – Pending

1. CBOE v. ISE – ISE’s patents asserted against CBOE.
2. 5th Market v. CME - U.S. Pat. No. 6,418,419 entitled “Automated System for Conditional Order Transactions in Securities or Other Items in Commerce”
3. Every Penny Counts Inc. v. Bank of America Corp. et al., case no. 07-42 (MD FLA). Defendants are seeking to reopen discovery to address the issue of whether the ruling in In Re Bilski makes the claims at issue invalid on patentability grounds.
4. Edge Capture v. Lehman – Stayed pending Lehman bankruptcy proceedings.
5. TT v. eSpeed; GL Trade; COG; RCG; FuturePath – Trading screen user interface
6. Papyrus Technology v. NYSE – Handheld floor technology.
7. Lava Trading v. Sonic Trading Management - trading system for consolidation of trading on multiple ECNS.
8. NexTrade Holdings v. Philadelphia Stock Exchange – Long dated and expirationless options.

II. Technology Focused

1. TQP Development LLC v. Merrill Lynch & Co. Inc. et al., case no. 08-cv-00471 (ED Tex.).

Exhibit C. Recent Significant Patent Cases

I. U.S. Supreme Court

1. **Licensing/exhaustion:** Sale of an invention exhausts the patent holder's ability to restrict how the product is used by the purchaser. Quanta Computer, Inc. v. LG Elec., Inc., 128 S. Ct. 2109 (2008).
2. **Obviousness:** A patent is invalid due to obviousness over the prior art based on the understanding of "one of ordinary skill in the art." KSR v. Teleflex, 550 U.S. 398 (2007).
3. **Licensee's Rights:** A licensee may bring an action for invalidity of a licensed patent without first breaching a licensing agreement. Medimmune v. Genentech, 549 U.S. 118 (2007).
4. **Exportation:** No infringement existed when a "golden disk" of patented software is exported. AT&T v. Microsoft, 550 U.S. 437 (2007).
5. **Injunction:** A permanent injunction is not automatic after a finding of infringement. eBay v. MercExchange, 547 U.S. 388 (2006).

II. Federal Circuit

1. **Subject Matter:** Held that that a patent claim must be tied to a particular machine or apparatus, or the claims must transform a particular article into a different state or thing. In re Bilski 88 U.S.P.Q.2d 1385 (Fed. Cir. 2008).
2. **Willfulness:** Held that willful patent infringement requires "objective recklessness." In re Seagate (Fed. Cir. 2007)
3. **Licensee:** Held patent holder's identifying potentially infringing activity to prospective licensee creates declaratory judgment jurisdiction. SanDisk v. STMicroelectronics (Fed. Cir. 2007)
4. **Obviousness:** Finding a business method patent on municipal bond auction process obviousness based on a combination of non-automated processes. Muniauction Inc. v. Thomson Corp., 532 F.3d 1318 (Fed. Cir. 2008).
5. **Obviousness:** Upholding the lower court's finding of obviousness, the Federal Circuit found that the "method of operation" is not given any weight and the court can apply common sense to the question of obviousness. Leapfrog Enterprises Inc. v. Fisher-Price Inc., 485 F.3d 1157 (Fed. Cir. 2007).
6. **Subject Matter:** Software implemented "business methods" are patentable subject matter. State Street Bank v. Signature Financial Group, 149 F.3d 1368 (Fed. Cir. 1998).

III. Foreign Jurisdictions

1. **Subject Matter:** A computer-based method of accessing data in a dynamic link library is patentable subject matter under s 1(2)(c) of the Patents Act 1977. A computer program involves "a technical contribution to the prior art which would

enable computers and related devices to work faster and more reliably.” Symbian Ltd v Comptroller General of Patents [2008] EWCA Civ 1066; [2008] WLR (D) 310

Exhibit D. Bilski Patent Application

U.S. Patent Application Serial No. 08/833,892

Claim 1:

A method for managing the consumption risk costs of a commodity sold by a commodity provider at a fixed price comprising the steps of:

- (a) initiating a series of transactions between said commodity provider and consumers of said commodity wherein said consumers purchase said commodity at a fixed rate based upon historical averages, said fixed rate corresponding to a risk position of said consumer;
- (b) identifying market participants for said commodity having a counter-risk position to said consumers; and
- (c) initiating a series of transactions between said commodity provider and said market participants at a second fixed rate such that said series of market participant transactions balances the risk position of said series of consumer transactions

**Selected Cases Relating to
Credit Default Swaps and Collateralized Debt Obligations**

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I. CREDIT DEFAULT SWAPS ARE STRICTLY CONSTRUED.

Litigation relating to credit default swaps (“CDSs”) is expanding. Although few cases have been decided, the one clear trend is that CDS disputes are disputes over complex contracts, with the courts closely scrutinizing the language of documents, presuming it to be carefully negotiated between sophisticated parties. Several examples of that consistent trend are provided here.

A. *VCG Special Opportunities Master Fund Limited v. Citibank*, No. 08-01563, 2008 WL 4809078 (S.D.N.Y. Nov. 5, 2008).

1. Background.

VCG, a hedge fund, sold a credit default swap to Citibank whereby, in exchange for periodic fixed payments from Citibank, VCG agreed to pay Citibank a “Floating Payment” of up to \$10 million if specified “Floating Amount Events” occurred. The potential events included an “Implied Writedown” with respect to the reference obligation (Class B Notes of a CDO). Specifically, the CDS provided that if the reference obligation’s underlying instruments did not expressly provide for “Writedowns,” Citibank, as the calculation agent, could determine whether an “Implied Writedown” had occurred. The CDS also gave Citibank the right to demand additional collateral based on the mark-to-market value of the reference obligation.

VCG deposited \$2 million as collateral and Citibank later demanded, and VCG paid, additional collateral of almost \$8 million. VCG repeatedly questioned Citibank’s calculations and believed it was not obligated to make the payments demanded. Nonetheless, VCG continued to post collateral, allegedly out of concern that Citibank would declare VCG in technical default and seize the collateral. When Citibank later advised VCG that an Implied Writedown had occurred and that the \$10 million floating payment was due, VCG refused to pay. Citibank foreclosed on the collateral and demanded VCG pay the remaining amount due under the CDS. VCG filed a complaint for a declaratory judgment that an Implied Writedown had not occurred; rescission of the CDS based its mistaken understanding of the terms of the agreement; breach of contract; breach of the implied covenant of good faith and fair dealing; and unjust enrichment. Citibank counterclaimed for breach of contract.

2. CDS Contracts are Strictly Construed.

¹ This material reflects an attempt to objectively summarize publicly available information. It is not an attempt to evaluate the merits of any case and should not be interpreted as expressing the view of Morgan Stanley & Co. Incorporated on any matter.

The court entered judgment on the pleadings in favor of Citibank on each of the claims and the counterclaim. The court concluded that Citibank was authorized by the terms of the CDS to determine that a Floating Amount Event in the form of an Implied Writedown had occurred. Similarly, the court rejected VCG's claim for rescission based on the ability of Citibank to request additional margin collateral as the value of the reference obligation deteriorated. VCG claims that it believed it was agreeing "to sell credit protection on a credit default swap" and "not to take the risk of daily mark-to-market movement in the value of the reference obligation." The court found that VCG was a sophisticated hedge fund and that the CDS language was clear. VCG could not seek rescission if it "simply failed to review carefully the terms of the parties' agreement."

3. Waiver.

VCG also alleged that the language of the CDS did not support Citibank's demand for additional collateral and that Citibank abused its role as Calculation Agent to demand increasing collateral. The court concluded that VCG had waived its right to challenge the demands for additional collateral by posting the disputed collateral and accepting Citibank's regular payments under the CDS at the time.

4. Alternative Dispute Resolution.

The court also found that VCG's contractual objection to the demand for additional collateral failed because VCG had failed to invoke a mandatory dispute resolution provision in the CDS prior to filing the complaint. That mechanism, which allowed expedited dispute resolution, was mandatory and precluded litigation of the contract claims in court.

VCG is appealing the court's order; the Second Circuit has not yet ruled.

B. *Aon v. Societe Generale*, 476 F.3d 90 (2d. Cir. 2007).

1. Background.

The case arose from two credit default swaps related a \$10 million loan by a Bear Stearns International Limited entity ("BSIL") to a construction project in the Philippines. As part of the loan transaction, BSIL required the borrower to obtain a surety bond from the Governmental Service Insurance System ("GSIS"), a Philippine government agency naming BSIL as the obligee. To hedge its risk on that surety bond, BSIL bought protection from a default by GSIS in a credit default swap from Aon (the "BSIL/Aon CDS"). The BSIL/Aon CDS defined a "Credit Event" as the "failure of [GSIS] to make, when due, any payments" under the surety bond. Aon, in turn, hedged its risk on the BSIL/Aon CDS with a credit default swap from Societe Generale (the "Aon/SG Swap") to reduce its own risk. The Aon/SG Swap had a different and more complex definition of a Credit Event, described below.

The borrower defaulted on its loan from BSIL and GSIS refused to pay on the surety bond to an assignee of BSIL because GSIS believed the bond had not been properly assigned. BSIL's assignees sued Aon on the BSIL/Aon Swap and prevailed, the court finding that the BSIL/Aon CDS required payment if GSIS failed to pay "for any reason." *Ursa Minor Ltd. V. Aon Fin. Prods., Inc.*, 2000 WL 1010278, at *6 (S.D.N.Y. July 21, 2000). Aon then sued Societe

Generale, arguing that if a Credit Event occurred under the BSIL/Aon Swap, it “must also have occurred under the Aon/SG CDS.” The District Court determined that a Credit Event had occurred, because “GSIS’ []s act had the effect of causing a failure to honor an obligation relating to the Philippine government.” *Aon Fin. Prod. v. Societe Generale*, 2005 WL 427535 at * 16 (S.D.N.Y. Feb. 22, 2005).

2. Contract Language will be Reviewed Independent of Other Circumstances and Strictly.

The Second Circuit reversed, determining that the Aon/SG CDS should be interpreted on its face without reference to the BSIL/Aon CDS because the terms of each CDS independently defined the risk being transferred. *Aon Financial v. Societe Generale*, 476 F.3d 90 (2d. Cir. 2007). While the BSIL/Aon CDS defined a “credit event” to explicitly include a failure to pay by GSIS on the surety bond, the court concluded that the Aon/SG CDS did not. Instead, the could interpreted the AON/SG CDS to require payment in the event of “a condition ... created by or result[ing] from any act or failure to act by the [Philippine Government] or any agency or regulatory authority [thereof] ... that has the effect of ... causing a failure to hour any obligation relating to ... any obligation issued by the [Philippine Government].” The Second Circuit parsed this language extremely narrowly and literally, concluding that even if the letter from GSIL disputing payment was an “act” of the Philippine Government, it did not create a separate “condition” that caused the default on the surety bond.

3. Formalities will be enforced.

Additionally, the Second Circuit noted that SG was only obligated to pay Aon after Aon served SG with a “Credit Event Notice” and a demand for payment, which must be an “irrevocable notice” that a Credit Event has occurred. Aon relied on a letter it sent in connection with the litigation. In this letter, Aon asserted that although it had filed litigation against all parties, it did not believe Aon would be obligated to pay on the BSIL/Aon CDS, had named SG in that litigation “to preserve” Aon’s rights, and that under certain circumstances it would rescind the contention that SG owed Aon under the Aon/SG CDS. The court concluded that the notice was not “irrevocable” because it described circumstances in which SG would not be required to pay and the Second Circuit therefore concluded that it was inadequate as a “Credit Event Notice.”

C. ***Merrill Lynch Intl. v. XL Capital Assurance Inc.*, No. 08-Civ-2893 (July 15, 2008 S.D.N.Y).**

1. Background.

Merrill Lynch International (“MLI”) brought suit in the Southern District of New York for a declaration that XL Capital (“XL”) remained bound by a group of CDSs relating to underlying CDOs. The dispute related to whether MLI had entered into inconsistent contractual obligations relating to control of the senior tranche of the underlying CDOs and therefore had repudiated the CDSs with XL.

In the CDS between MLI and XL, MLI owned both the A-1 and A-2 “super senior” tranches but only purchased insurance from XL on the A-2 tranche. However, as part of XL’s

negotiations with MLI to insure the A-2 tranche, XL received assurances from MLI that it would not vote the A-1 tranche inconsistent with the direction of XL. MLI later entered into six other CDSs with other non-parties (“MBIA Swaps”) to insure the A-1 notes, and the new CDS agreements granted the MBIA parties (the sellers of protection) voting rights to the A-1 tranche, but only to the extent that MBIA’s instructions were not inconsistent with MLI’s obligations under other agreements.

XL notified MLI that by entering the new MBIA Swaps and granting MBIA the right to direct voting in the senior tranche, MLI had repudiated its agreement and triggered an “Additional Termination Event” entitling XL to exercise its termination rights in the six CDS agreements. MLI replied that it had not entered into any contract that divests MLI of its ability to comply with its obligations to XL, and it brought suit seeking a declaration that XL was still bound by the agreements. XL conceded that MLI had not yet breached the agreements, but it argued that MLI had anticipatorily breached the agreements by entering the MBIA Swaps.

2. Plaint Language Controls.

The court analyzed the “plain language” of the competing CDS agreements and granted MLI’s motion for summary judgment. The court noted that the MBIA Swaps contained a provision that notified the MBIA parties that MLI may have entered into other agreements which conflict with the MBIA parties’ voting rights for the underlying tranches and provided that the MBIA parties’ sole remedy—if such a conflict arises—is to terminate the agreement. Therefore, the court found that MLI had “fully retained the ability to abide by [XL’s] voting instructions” in entering the MBIA Swaps. The agreements provided MLI the right “to follow [XL’s] instruction and retain its coverage, or give up the coverage in order to protect itself in some better way with respect to the A-1 tranche.” The agreements did not grant “exclusive [voting] rights unconditionally” to MBIA and since XL had not issued any voting instructions that MLI ignored, XL had no grounds to issue the termination notices.

II. WATERFALL CASES.

Although few cases have been decided, many disputes have emerged relating to the distribution of assets among various classes of investors in CDOs. These “waterfall” cases generally involve interpleader actions, where the trustee of a CDO seeks judicial guidance on how to distribute funds. An example is provided below.

A. ***Deutsche Bank Trust Company Americas v. LaCrosse Financial Products LLC et al., Case No.7116014 (Filed Dec. 3, 2007).***

Deutsche Bank filed an interpleader action in New York state court acting as trustee and securities intermediary for a CDO after determining that an event of default as defined in the agreement had occurred, seeking guidance on the payment of proceeds from the CDO.

According to the complaint, after the CDO defaulted, Deutsche Bank sought to apply the proceeds of the collateral in the order of the required priority of payments as determined by the waterfall provisions of the indenture. However, a dispute arose between the defendants concerning the proper interpretation of the subordination and waterfall provisions for the priority of payments. LaCrosse, the super-senior counterparty and controlling class, demanded an

acceleration and immediate payment of principal on the secured notes and directed Deutsche Bank not to pay any proceeds to any noteholders before paying LaCrosse first. On the other hand, Cede & Co., the holder of record of the secured notes, argued that LaCrosse's interpretation was neither reasonable nor correct, and that a portion of the proceeds should be paid to it for the benefit of the secured noteholders.

The complaint asks the court to order defendants to interplead and to settle all claims between themselves and any other person who claims or may claim an interest in the proceeds, to order Deutsche Bank to make interim distributions only by further order of the court, to distribute the amounts remaining upon final judgment as directed by the court, and to, pending such final judgment, enjoin defendants from commencing any separate litigation concerning or relating to the issues in this action.

The matter has not been resolved.

III. **FRAUD/MISREPRESENTATION RELATED TO CDOs.**

The unprecedented decline in the credit markets led to poor performance by certain CDOs. Investors in some cases have claimed that they were not properly informed of the risk of such performance and in others that the structure of the transaction improperly provided an opportunity for abuse. In both of the examples below, investors allege that misrepresentations were made in connection with investments in CDOs. In both cases, the CDOs earned income through credit default swaps by providing protection against a pool of assets controlled by the counterparties. Both plaintiffs allege that their counterparties abused their position in the transaction to transfer exposure to the plaintiff of risky assets. Neither case has been decided on the merits.

A. ***HSH Nordbank AG v. UBS AG and UBS Securities LLC.***

a) Background.

HSH Nordbank brought suit in February 2008 in New York state court against UBS to recover losses on a \$500 million dollar investment in the North Street 2002-4 CDO ("North Street 4"), a hybrid collateralized debt obligation arranged, underwritten and managed by UBS and a related CDS based on a \$3 billion reference pool of securities between the CDO and UBS.

According to the complaint, in 2002, HSH, then a regional bank claiming "little experience in international structured finance," wanted to invest funds in a diversified portfolio of international assets with an emphasis on real estate related credit. UBS proposed the CDO-based structure of North Street 4 as a conservative, relatively low-return investment in securities backed mainly by U.S. real estate assets. HSH claims that UBS represented that HSH's interest would be in very high quality paper issued by the CDO and assured HSH that, as an investor in the senior tranches of North Street 4, HSH would have the further protection of structural subordination. HSH purchased only the more senior tranches of North Street 4 for this added protection. In addition, UBS allegedly represented that North Street 4 would be backed by a reference pool of stable, investment grade collateral through a CDS between the CDO and UBS. Under the terms of the CDS, North Street 4 alleges that it assumed the risk of default on a \$3 billion reference pool of debt securities selected by UBS and in return UBS agreed to make

periodic premium payments to North Street 4. UBS allegedly represented that the reference pool collateral would be subject to certain guidelines and an oversight committee to ensure its quality and stability.

HSH alleges that after the closing, notwithstanding these representations, UBS exposed HSH to less desirable collateral, through which USB stood to profit on the CDS. It claims UBS made collateral substitutions in direct and knowing contravention of its representations that it would make changes in the reference pool only with an objective of enhancing or maintaining stable credit quality. Furthermore, HSH claims that an oversight committee was never formed, let alone actually oversaw, the collateral, in direct breach of their agreement. It alleges that within one year, it had suffered a decline in the value of its investment in North Street 4 in excess of \$275 million.

HSH is alleging claims of breach of contract, fraud, negligent misrepresentation, breach of fiduciary duties owed to HSH, breach of implied covenant of good faith and fair dealing, unjust enrichment and constructive trust, for an injunction, and conversion. It is seeking rescission or, in the alternative, compensatory and punitive damages, attorneys' fees, and to enjoin UBS from continuing to breach its contractual obligations.

b) Status.

UBS sought to dismiss the claims, and succeeded in part. HSH's fraud claim and five others were dismissed in October, 2008, but the court ruled that HSH may continue its lawsuit against UBS on the breach of contract and breach of implied covenant of good faith and fair dealing claims. On December 10, HSH filed an amended complaint seeking to restore the fraud claim over UBS AG.

B. ***Kenosha Unified School District v. Stifel, Nicolaus & Co., Inc. and RBC: Milwaukee County Circuit Court: (Filed Sept. 28, 2008.)***

1. Background.

Several Wisconsin School Districts ("School Districts") sued to recover what they believe to be \$150 million in losses suffered after they invested \$200 million into three synthetic CDOs created and marketed by the Defendants. The synthetic CDO at issue earned income by selling protection through a credit default swap. Plaintiffs allege that the Defendants intentionally or negligently misrepresented or omitted the "nature, character, and risks of the investments."

The Plaintiffs alleged that the Defendants solicited the School Districts to borrow and invest money in order to fund its long-term benefit obligations. Plaintiffs allege that Defendants proposed a "complex, convoluted, and opaque" solution to help them fund their OPEB obligations which Defendants knew was "beyond the investment knowledge and experience of the School Districts." Defendants allegedly proposed that the School Districts borrow money and invest that money in the synthetic CDOs which would be used to collateralize the borrowing. The School Districts would then receive the difference between the cost of the borrowed money and the interest rate on the CDOs.

The School Districts allege that Defendants convinced the School Districts to fund these CDOs by misleading them into believing that the investment had a low risk, allegedly stated that the CDO investments were “safe AA/AAA type investments” and there is “no sub-prime debt within any of the CDOs.” The School Districts contend that, in fact, the CDOs, were riskier. Although the School Districts did not allege that the CDOs had failed to make any payments, they alleged that the CDOs had lost significant value.

The School Districts brought eleven claims for relief, including: violation of the Wisconsin Uniform Securities Act, the Wisconsin Deceptive Trade Act; Conspiracy; Intentional Fraud; Strict and Negligent Misrepresentation; Negligence; and Breach of Contract based on Defendants failure to follow FINRA’s and other regulatory rules which harmed the School Districts as the intended beneficiary. The School Districts are seeking rescission of the CDO transactions, and compensatory and punitive damages.

IV. SECURITIES CLASS ACTIONS.

Many class actions have been filed alleging that financial institutions knowingly concealed the deteriorating value of CDOs and the liabilities associated with CDSs. An example is *In re Merrill Lynch & Co., Inc. Securities, Derivative, and ERISA Litigation*, 07cv9633 (S.D.N.Y). In that case, Plaintiffs allege that Merrill Lynch & Co (“Merrill”) committed securities fraud when it concealed its recognition that the AAA-rated super-senior CDO tranches that it held were in fact “ultra risky.” Plaintiffs allege that Merrill concealed this fact in order to continue generating underwriting fees from the CDO business. Plaintiffs argued the Defendants deliberately committed securities fraud by continuing to issue CDOs and thereby allegedly increasing Merrill’s U.S. subprime CDO exposure. Plaintiffs also alleged that Merrill’s stock declined 49% as a “direct and proximate result” of the alleged fraud. Merrill has moved to dismiss the Complaint.



FOLEY & LARDNER LLP

**2009 WINTER MEETING -- ABA COMMITTEE ON THE REGULATION
OF FUTURES AND DERIVATIVES:**

**BANKRUPTCY ISSUES FOR FUTURES, DERIVATIVES AND
SECURITIES MARKETS**

Presented By:

Geoffrey S. Goodman, Foley & Lardner LLP



Starting Premises

- I. Objectives of System: To protect investor funds, maintain financial integrity of the markets (avoidance of systemic risk) and promote investor confidence, it is important that regulatory safety net mechanisms (e.g., capital requirements and early warning triggers, segregation of investor funds, periodic government or SRO audits) and related Bankruptcy Code provisions accomplish three objectives:
 - Legal certainty with respect to treatment of funds
 - Assurance of speed and finality of actions
 - Protect the “right” people (a normative judgment but one that is made)
- II. Market Complexities + Segmented Regulatory Framework + Segmented Bankruptcy Code Framework + Misalignment of Regulation and Bankruptcy Code + Dynamics of Bankruptcy Process
- III. Time to Reevaluate

TODAY'S FINANCIAL MARKETS ARE COMPLICATED

- Interdependencies
 - Process – Futures market illustration
 - Organizational – Intercompany relationships within financial conglomerates
 - Refco had over 30 affiliated entities, ***both domestic and foreign, regulated and unregulated***
- Multiple business activities and/or registrations within a single financial markets intermediary
 - Lehman Brothers was dually registered with the CFTC as an FCM and with the SEC as a BD
 - Sentinel was dually registered with the CFTC as an FCM and with the SEC as an investment adviser
- Markets are Global

SEGMENTED REGULATION FOR FINANCIAL MARKETS

- **Different laws regulating different segments of the financial markets and/or different classifications of financial market professionals**
 - CEA for futures markets and FCMs; federal and state securities laws for securities markets and BDs; federal and state banking laws
 - OTC derivatives generally not subject to regulation; governed primarily by contractual relationships

SEGMENTED REGULATION FOR FINANCIAL MARKETS (cont'd)

- Different federal regulators, e.g., CFTC, SEC, banking agencies
- Different safety net mechanisms
- Segmentation means that safety net mechanisms have limited reach and leave areas of exposure. This is a central lesson of Sentinel
- Segmentation means there can be competing regulatory objectives and conflicts between regulators

BANKRUPTCY CODE CONSIDERATIONS

- **Bankruptcy Code is segmented to attempt to correspond to the segmented legal framework**
 - Commodity brokers – Subchapter IV of chapter 7 of Bankruptcy Code; provisions added to Code in 1978
 - Stockbrokers – Subchapter III of chapter 7 of Bankruptcy Code added in 1978; SIPA enacted in 1970
 - Forward contracts and swap agreements – Provisions added to Code in haphazard manner over the years
- **This is important in terms of coordinating actions taken pre-bankruptcy when a financial intermediary is threatened with insolvency and post-bankruptcy**
 - Transfer of futures customer accounts from a failing FCM to another FCM in the period before the failing FCM files for Chapter 7 bankruptcy
 - Protection against claw back for distributions of segregated funds made prior to the petition date

BANKRUPTCY CODE CONSIDERATIONS (cont'd)

- **Misalignment between Bankruptcy Code and regulation:**
 - Scope: Definitions in the Code don't always fit the definitions that apply outside a bankruptcy context
 - Sentinel: FCM versus “Commodity Broker”
 - Refco: Non-registered (SEC or state) offshore firm deemed “stockbroker” under the Code
 - Policies
 - Typical bankruptcy concerns of equitable treatment of all creditors of the bankrupt firm and maximizing the size of the bankruptcy estate versus protection of defined investor classes, protection against system risk, enhancing legal certainty and prompt final actions
- **Assumptions made in 1978 and at other times may not hold true**
 - Intercompany transactions can significantly complicate issues
 - Possibility of fraud
 - Multiple activities within a single firm
 - Competing regulatory structures

SENTINEL MANAGEMENT GROUP, INC.

- Sentinel billed itself as an “investment adviser” to FCMs, hedge funds, pension funds and individuals.
- In order to be able to invest FCM customer funds pursuant to CFTC Rule 1.20, Sentinel registered as a non-clearing FCM with the CFTC. It was also a member of the National Futures Association.
- Sentinel was also registered with the SEC as an investment adviser under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq.
- Sentinel marketed to FCMs by offering to handle their investments of short-term cash in a purportedly “safe” 1.25 Portfolio (named after CFTC Rule 1.25).

SENTINEL MANAGEMENT GROUP, INC.

(cont.)

- Sentinel split its customer groups into “Segs”
 - Seg 1 – FCM customer funds (governed by Commodity Exchange Act and CFTC Rules)
 - Seg 2 – funds of FCM customers trading in foreign exchanges (CFTC Rule 30.7)
 - Seg 3 – funds of all other customers, including hedge funds, wealthy individuals and FCM “house” funds.
- Sentinel had over \$1 billion under management in 2007.
- Sentinel used Bank of New York (“BONY”) as its custodian for customer funds.

SENTINEL'S COLLAPSE

- Risky Investments -- Allegations of certain customer funds being invested in risky (and ultimately unprofitable) investments such as subprime debt in order to finance insider profits.
- No Redemption Letter – On 8-13-07, Eric Bloom sends letter advising customers that Sentinel was halting redemptions of customer funds

SENTINEL'S COLLAPSE (cont.)

- **On 8-16-07, Sentinel sells Seg 1 Securities to Citadel Equity Fund, Ltd. (“Citadel”) for approx \$320 million (perceived to be at deep discount)**
 - FCMs initiate litigation to (unsuccessfully) attempt to prevent sale and obtain access to their customers’ funds.

SENTINEL'S BANKRUPTCY CASE

- **Not a “Commodity Broker” Liquidation**
 - Filed as a chapter 11 case; not a “commodity broker” chapter 7 liquidation.
 - Apparent “Gap” in Code: To be a “commodity broker” under the Code, the FCM must have a “customer.”
 - The definition of “customer” appears to require the customer to have a claim arising out of a “commodity contract” (i.e., a futures contract)
 - FCM customers of Sentinel did not enter into futures contracts with Sentinel (they only did so with their own customers)

SENTINEL'S BANKRUPTCY CASE **(cont'd)**

- Funds of FCM customers caught up in bankruptcy case
- Immediate motion by Sentinel to have Citadel proceeds released to Customers of FCMs

SENTINEL'S BANKRUPTCY CASE (cont.)

- **CFTC and SEC take opposing positions at Hearings on Release of Citadel Proceeds**
 - CFTC alleges that “Eleven FCMs will fail if the money is not distributed” and warns of a “ripple effect” on the market if the funds are not released.
 - SEC alleges that Sentinel engaged in a massive “commingling” of customer funds that should prevent distribution of such funds to the customers of the FCMs (to the exclusion of Seg 3 customers).
 - Judge Kennelly remarks: “Why doesn’t this agency of the government go over and talk to this agency of the government and get your act together, for crying out loud.”

SENTINEL'S BANKRUPTCY CASE (cont.)

- **Courts Authorize Release of Funds to FCMs**
 - In rejecting Seg 3 argument not to release funds, Judge Kennelly remarks: “So what I am supposed to weigh then is your client’s \$400 million against what I was told are the ripple effects that will reverberate through the economy . . . **That’s a no brainer.**”
 - Not clear that every Judge would necessarily have done the same thing.
 - FCMs’ customers paid 71% on account of their customer fund claims.

LITIGATION IN SENTINEL AGAINST THE FCMs

- **18 Months Later: FCMs Sued and Judge Squires Allows Cases to Proceed**
- Suits by Trustee against the FCMs to recover Citadel Proceeds.
- Trustee alleges that the FCMs have been “overpaid” due to alleged “commingling” of customer funds and cannot “trace” their particular assets.
- **Bankruptcy Judge Squires “clarifies” that his August 2007 order does not preclude the Trustee from suing to recover from the FCMs the 71% transferred to the FCMs’ customers.**
- Funds treated as “good capital” by regulators now subject to potential disgorgement
 - “Clarification” by Judge Squires made despite the amicus brief filed by the CFTC against the clarification.
 - SEC supports the Trustee’s right to sue the FCMs to protect the interests of the Seg 3 customers, again creating the spectrum of a dispute between regulators in front of the Bankruptcy Court.

LITIGATION IN SENTINEL AGAINST THE FCMs (cont.)

- **Commodity Exchange Act versus typical “property of the estate” litigation in Bankruptcy Court**
 - Are the FCMs required to identify and trace every security held by Sentinel in Seg 1 to establish that their assets are not property of the Sentinel bankruptcy estate?
 - Does the CEA and applicable case law provide otherwise?
 - CFTC Statement – “It would be paradoxical if misconduct by an FCM in regard to maintenance of segregation would negate the purpose of segregation, which is to ensure that FCMs treat customer funds as the property of customers.”

LITIGATION IN SENTINEL AGAINST THE FCMs (cont.)

- **Another Potential Battleground – Are the FCMs “transferees” under Section 550 of the Bankruptcy Code?**
 - Trustee may only avoid alleged preference payments made to “transferees.”
 - Citadel payments and all other transfers made to customer accounts at FCMs, accounts in which FCMs had no property or other interest.
 - Did the FCMs “receive” such transfers?
 - Are the FCMs “mere conduits” for their customers?

LITIGATION IN SENTINEL AGAINST THE FCMs (cont.)

- **Trustee Expands Battle against FCMs by Suing on more than Citadel Transfers**
 - Trustee sues to recover all transfers made to customer accounts of FCMs within 90 days of Sentinel filing chapter 11
 - Alleges that Sentinel was a “Ponzi Scheme” or similar fraudulent enterprise
 - Under “Bayou” theory, Trustee could seek to recover transfers made to customer accounts of FCMs (and others) going back 2-4 years.

Other Litigation Initiated By The Sentinel Trustee

- **Insiders** -- Settles for \$10.7 million in May 2008 due to lack of additional available assets
- **McGladrey & Pullen** -- Professional negligence and alleged misconduct claim (\$550 million in damages sought)
- **Citadel** – Fraudulent transfer claim related to Citadel Sale

Other Litigation Initiated By The Sentinel Trustee (cont.)

- **BONY -- Alleged Secured Lender of Sentinel**
 - BONY sued for aiding and abetting insiders' breach of fiduciary duty to Sentinel
 - Trustee also seeks to avoid BONY's alleged liens, subordinate its claims and recover alleged fraudulent and preferential transfers
 - **BONY argues that the CEA does not apply because Sentinel is not a "true FCM," despite being registered as such with the CFTC, because it did not engage in futures trading**
 - CFTC files an amicus brief rejecting BONY's contentions given, among other things, BONY's prior letters acknowledging the CEA and customer funds requirements of Sentinel and its customers
 - BONY also argues that the Trustee cannot recover any alleged fraudulent or preferential transfers **because the funds were owned by Sentinel's customers**
 - BONY case has significant impact on litigation against FCMs

REFCO: STOCKBROKER LIQUIDATIONS AND GAPS IN THE BANKRUPTCY CODE

- **The Code has special provisions that apply to a “stockbroker.”**
 - Stockbrokers must be liquidated under subchapter III of chapter 7 of the Code.
 - Customers of stockbrokers are given priority over non-customers to “customer property.”

REFCO: STOCKBROKER LIQUIDATIONS AND GAPS IN THE BANKRUPTCY CODE (cont.)

- **Definition of “Stockbroker”** – A person who (a) has a “customer,” and (b) effects transactions in securities (i) for the account of others, or (ii) with members of the general public, from or for such person’s own account.
 - Legislative History – Definition “is a concatenation of the definitions of ‘broker’ and ‘dealer’ in the Securities Exchange Act of 1934.”
 - No requirement of being a registered broker/dealer to be a “stockbroker”; however, per legislative history and case law, many assumed lack of registration requirement meant to pick up only intrastate brokers and perhaps unregulated entities using regulated affiliates to effectuate transactions.

REFCO: STOCKBROKER LIQUIDATIONS AND GAPS IN THE BANKRUPTCY CODE (cont.)

- **Refco Capital Markets, Ltd. (“RCM”) – Unregulated Bermuda entity engaging in securities, FX, derivatives and other custodial transactions**
 - Bankruptcy Court rules that RCM is a “stockbroker” due to broad “plain meaning” of statute.
 - Only securities customers receive priority under the Code.
 - FX, derivatives and other customers, who were equally defrauded, were structurally subordinated to securities customers because they are not securities “customers” under the Code.
 - Recoveries to Date from RCM:
 - Securities Customers = approx. 90%
 - FX and Derivatives Customers = approx. 45% (same as general unsecured creditors)

DYNAMICS OF THE BANKRUPTCY PROCESS

- **Rules of Engagement Change**
 - When claims of multiple creditors exceed assets against which claims are asserted, creditors have an incentive to exploit complexities to their advantage
 - Additional forum for regulatory conflicts to play out
 - Experience or lack thereof of court or trustee with financial markets and their regulation and sorting through the competing creditor claims and arguments
- **These dynamics threaten legal certainty with respect to the safety net mechanisms and the related Code provisions, especially when provisions may be dated**
 - Risks of an outcome in the bankruptcy proceeding that is contrary to the outcome intended under the safety net mechanisms
 - Can prejudice firms and individuals as well as create systemic risk for market

CONCRETE LESSONS FROM RECENT BANKRUPTCIES

■ Sentinel

- The current structure of the Bankruptcy Code puts customers at risk of losing their priority treatment through the “back door.”
 - FCM registration and “commodity broker” under the Code are not the same thing
 - Commodity broker provisions do not apply to third parties holding customer segregated funds
 - This issue played out in the subsequent troubles of **Reserve Primary Fund**
- In the event of a bankruptcy or other insolvency proceeding by a bank, depository institution or Sentinel-like FCM, the FCM and by extension, their customers, could lose their priority treatment, if the Trustee’s position is adopted, absent an ability to “trace” customer funds.
- The alleged requirement of “tracing” brings us back to pre-1978 days.
- FCMs and customers are betting on the “good behavior” of their custodians without a statutory backstop.
- Even Bankruptcy Court Orders that help avoid the consequences of a fragmented Code structure can be subject to attack
- Regulatory conflicts
 - Dispute between CFTC & SEC over release of segregated funds
 - Open issue of CEA segregation versus Investment Adviser Act segregation
 - Net capital treatment of funds tied up at Sentinel

CONCRETE LESSONS FROM RECENT BANKRUPTCIES (cont'd)

- **Sentinel** (cont'd)
- Even if customer funds are traceable in the hands of a bank, other approved depository institution or Sentinel-like FCM, an insolvency of such an entity could result in delays.
 - No requirement as in section 766(c) of the Code to promptly transfer customer accounts to a solvent entity.
 - FCM clearing members meeting daily margin calls would be particularly burdened by a lack of immediate access to customer funds
 - May not be good regulatory capital to meet minimum capital requirements
 - Capital violation can have spinoff effect with non-clearing members and market as a whole

CONCRETE LESSONS FROM RECENT BANKRUPTCIES (cont'd)

■ **Refco**

- Bankruptcy Courts may determine that the Bankruptcy Code's definition of "stockbroker" does not follow the 1934 Act
- Customers dealing with offshore entities may unwittingly be subject to a regime in which their claims are subordinated
- No legal certainty on many aspects of "stockbroker" definition
- Foreign hedge funds trading third-world debt may be treated better in bankruptcy than U.S. based mutual funds—Code may not be protecting the "right" people

IS IT TIME TO REEVALUATE THE PATCHWORK APPROACH?

- **Does a segmented approach to regulation of financial markets and participants make sense?**
 - Single regulator?
 - Formal Commission of Chairs of existing regulators to act when a financial firm is threatened with failure or becomes the subject to a bankruptcy proceeding

- **Overhauling the Bankruptcy Code?**
 - Should we rely on Judges to “get it right”
 - The Code seems stuck in 1978
 - The Code was not designed for innovation in terms of new kinds of entities that do not fit into static Code definitions
 - Nor does the Code have a mechanism for protecting a broader universe of “customers”
 - The Code may be inadequate for addressing the complexities that exist today where financial services firms and/or their affiliates may have multiple regulators (CFTC, SEC, banking regulators) and intercompany transfer/fraud issues

IS IT TIME TO REEVALUATE THE PATCHWORK APPROACH? (cont'd)

- **Overview of Certain Options for Bankruptcy Code Overhaul**
 - Single class of protected customers without regard to current distinctions?
 - Broader class of “customers” entitled to protections?
 - “Need for speed” built into process?
 - Specialized bankruptcy courts with venue to handle cases?

**American Bar Association
Section of Business Law
Committee on Regulation of Futures & Derivatives Instruments, January 2009 Meeting, Puerto Rico
Civil Litigation Panel**

**Topic: Professional Responsibilities
Concerning Conflicts and Waivers**

**Presentation by Michael Sackheim
Sidley Austin LLP, New York**

<u>A</u> Type of Conflict	<u>B</u> Typical Fact Pattern	<u>C</u> Relevant Authorities ¹	<u>D</u> Observations
(1) Representing Opposing Sides in Litigation	Each opposing party requests the lawyer to represent it.	NY City Bar Opinions 2001-02 and 2006-1 provide guidance. ABA Opinion 05-436 discusses standards for waivers. Comment 31 to ABA Model Rule 1.7 provides that common representation will be inadequate if one client asks the lawyer not to disclose relevant client information to the other client.	Lawyer cannot represent both sides in litigation. ABA Model Rule 1.7(b)(3) provides that representing both sides in the same litigation is not waivable. <i>See generally, Nunez v. Lovell</i> , 2008 U.S. Dist. LEXIS 77902 (D.V.I. 2008). In a transactional matter, dual representation based upon an informed waiver may be possible. ABA Rule 1.7 and Comment 10 requires that an effective waiver must be in writing. The waiver in the transactional matter should provide that the lawyer will not represent either side in a dispute concerning the transaction.
(2) Advance Waivers to be	New client asks lawyer to represent	ABA Model Rule 1.7, Comment 22, sets forth the criteria required to have an effective waiver: a	An effective waiver to permit the lawyer to represent a new client adverse to the existing

¹ ABA Model Rule of Professional Conduct 1.7 (and its official Comments) is the most significant ethics rule concerning conflicts. ALI Restatement of the Law Governing Lawyers - Chapter 8 also provides guidance. The relevant local jurisdiction's ethics rules and opinions must be consulted in a conflicts matter. For example, whereas Illinois and the District of Columbia have adopted the ABA Model Code, the New York Lawyer's Code of Professional Responsibility contains material differences from the ABA Model Code. The views expressed in this outline are not necessarily the views of Sidley Austin LLP.

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Adverse to a Client in Litigation	it against an existing client with respect to a matter the law firm has not previously advised the existing client.	<p>writing containing a comprehensive explanation of the types of future litigation being waived as opposed to an open-ended general waiver.</p> <p>NY City Bar Opinion 2005-2 discusses the prohibited use of confidential information obtained from one client on behalf of another client.</p>	<p>client in litigation should be a specific waiver, not a general waiver. The same guideline also applies to transactional waivers.</p> <p><u>Celgene Corporation v. KV Pharmaceutical Company</u>, 2008 U.S. Dist. LEXIS 58753 (D. N.J. 2008). Magistrate declined to enforce an advance written waiver by a current client consenting to the law firm being adverse to the client in litigation generally. In the pending patent infringement litigation, based on the waiver not being an “informed consent” with full disclosure of the potential material implications of the law firm being adverse to the existing client in future patent enforcement litigation, the Magistrate disqualified the law firm. It did not help that the engagement partner who drafted the waiver testified that he did not believe it was an effective waiver. The lesson learned is that the more specificity with which the waiver addresses future litigation, the greater is the potential for the waiver to be determined to be effective.</p>
(3) Representing Client Whose “Position” is Adverse to Another Current Client	Client X wants the law firm to represent it in a lawsuit against current Client Y or take a position in litigation that is materially adverse	<i>See, e.g.,</i> <u>Sumitomo Corporation v. J. P. Morgan & Co., Inc.</u> , Comm. Fut. L. Rep. ¶28, 001 (S.D.N.Y. 2000). In this commodities case, on a motion to disqualify Sumitomo’s counsel on conflicts grounds in a consolidated action that pitted Sumitomo positionally adverse to JPMorgan, the Court found that although Sumitomo’s law firm also represented JPMorgan	Informed consent must be obtained from both clients and the law firm must be able to diligently and competently represent both clients. Lawsuits against “former” clients in matters not related to the prior representation may be permitted. <i>See</i> , ABA Model Rule 1.9(a).

<u>A</u> Type of Conflict	<u>B</u> Typical Fact Pattern	<u>C</u> Relevant Authorities ¹	<u>D</u> Observations
	to Client Y.	in numerous matters unrelated to the pending commodities litigation, because JPMorgan was a large institution that used numerous law firms, and the law firm’s representation would not adversely impact its vigorous representation of JPMorgan in unrelated matters, the Court refused to disqualify the law firm from representing Sumitomo.	
(4) Firm Drops Client X to Represent Client Y (the “Hot Potato Conflict”)	Once a year for several years, Client FCM/BD, a small entity, requests law firm to review a customer futures agreement. Client Y, a large financial holding company, requests that law firm represent it in suing Client FCM/BD on a very large securities matter. Law firm decides to send Client FCM/BD a letter advising it	NY City Bar Opinion 2005-05 permits the dropping of a client under the circumstances described in the opinion. Considerations include (a) the conflict may not be brought about through the fault of the lawyer, (b) the lawyer should not drop one client for opportunistic reasons in dereliction of the lawyer’s duty of loyalty and (c) confidentiality issues concerning the dropped client.	Court cases are divided on this issue. Much depends on the nature of the conflict, the history of the lawyer – client relationship, the disclosures made by the law firm and when the conflict arose with respect to the dispute, among other factors.

<u>A</u> Type of Conflict	<u>B</u> Typical Fact Pattern	<u>C</u> Relevant Authorities ¹	<u>D</u> Observations
	will no longer act as its counsel in any matter.		
(5) Beauty Contest Interview	Client X wants to interview you concerning representing it in a multi-party litigation.	ABA Opinion 90-358 and NY City Bar Opinion 2006-02 set forth standards for not creating a lawyer-client relationship at the interview.	You do not want to create a lawyer-client relationship at the interview. Obtain an effective informed written waiver in advance of the meeting, including concerning potential confidential information that may be discussed and a disclaimer of the lawyer-client relationship. However, in this type of situation, it may be impossible to have an effective waiver.
(6) Lawyer Changes Firm	Law firm generally represents Client X. Lawyer leaves to join a new law firm, which represents parties who are in litigation against Client X.	ABA Model Rule 1.9 entitled “Duties to Former Clients” provides the standards with respect to being associated with a new law firm that represents a client whose interests are materially adverse to the interests of the lawyer’s former client about whom the lawyer had acquired materially confidential or protected information.	Law firm should implement an effective “screen” around the new lawyer. Some jurisdictions require an effective informed written waiver.
(7) Joint Representation of a Corporate Entity and Employee in a Government Investigation; Interviewing	Responding to a formal order of investigation into the OTC trading activities of an energy company and its senior trader, both the and	NY City Bar Opinion 2004-2 permits dual representation if a disinterested lawyer would believe that multiple representations is in the best interests of both clients and both clients must waive any conflict in writing. NY City Bar Opinion 2005-2 discusses confidentiality issues. CFTC Rule 11.8(b) addresses sequestration of	Effective informed written waivers should always be obtained to permit joint representation. Employee may need to waive attorney-client privilege to permit disclosure to the corporation and, if the corporation directs, to the government. Most often, such joint representation is not feasible or advisable and the corporation decides to pay for independent

<u>A</u> Type of Conflict	<u>B</u> Typical Fact Pattern	<u>C</u> Relevant Authorities ¹	<u>D</u> Observations
Corporate Employees	its sales manager request that you represent them before the CFTC.	counsel.	<p data-bbox="1329 329 1906 362">counsel for the employees.</p> <p data-bbox="1329 394 1906 1271">Counsel conducting an internal investigation may need to “Mirandize” interviewed employees, advising that (i) they may want to retain independent counsel, (ii) their statements may be turned over to the CFTC pursuant to an official proceeding and (iii) any misrepresentations to the lawyer may constitute obstruction of justice. In <u>U.S. v. Singleton</u>, (S.D. Texas, indictment filed Nov. 17, 2004), the Justice Department indicted an employee of an energy company alleging obstruction of justice in violation of 18 U.S.C. §1512(c)(2) based on false statements he made to outside corporate counsel conducting an internal investigation into the false reporting of natural gas trades in violation of the CEA. The indictment alleged that the employee misrepresented to the law firm the fact that he had provided false trading information to trade publications with the “belief” that the outside counsel would provide his statement to the CFTC and FERC pursuant to official proceedings conducted by those agencies and that the corporation in fact gave the CFTC and FERC copies of its counsel’s investigative report containing the allegedly false statement.</p> <p data-bbox="1329 1304 1906 1398">Corporation may pay an employee’s legal fees based on a contractual indemnification and government may not interfere with such an</p>

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			arrangement, but may consider whether the arrangement was intended to impede the investigation. <i>See</i> “Principles of Federal Prosecution of Business Organizations” (Department of Justice, December 2006); and <u>U.S. v. Stein, et al.</u> , 435 F. Supp 2d 230, 365-69 (S.D.N.Y. 2006).
(8) Corporate Client’s Affiliate May Also Be Your Client Also; Can You Be Adverse to the Affiliate?	Law firm regularly represents FCM on its futures customer agreements. FCM is a subsidiary of a larger financial holding company that has over 100 affiliates. Law firm is approached by a purchase of a commodity-indexed note to sue the issuer of the note – the financial holding company, alleging that the note did not satisfy the Section 2(f) exemption. The FCM was not involved in the issuance or sale of the notes. Does the	Comment 34 to ABA Model Rule 1.7 should be consulted. ABA Opinion 95-39 provides guidance as to factors that may make a client’s corporate affiliates your client: (a) there is a general disregard of corporate separateness (“alter-ego” theory), (b) in representing the corporation the law firm requires relevant confidential information about the affiliate, and (c) legal matters for the corporate family are handled by the same in-house lawyers or legal department. NY City Bar Opinion 2007-03 is also instructive.	The best advice is to address the affiliates issue in the engagement letter with the client. Also, there are business relationship issues that need to be considered.

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	law firm's representation of the FCM preclude it from suing the FCM's parent?		
(9) Taking Inconsistent Positions in Different Litigations	The law firm advises many swap dealers on documentation issues. New client End-User requests that law firm argue in litigation a position adverse to the general interests of swap dealers, which position is opposite to the advice that the law firm generally gives to its swap dealer clients, <u>e.g.</u> , the client wants the law firm to argue that contractually agreed termination payments are unenforceable penalties.	ABA Opinion 93-377 suggests that the law firm must either not represent the new client or obtain informed written waivers from both clients. <i>See, e.g., Williams v. State</i> , 805 A.2d 880 (Del. 2002) (unethical for lawyer to make opposing arguments on the same issue before the same appellate court).	Good advice is to confer with the attorneys at your firm who advocated the opposing position. You don't want to have "conflicts" with your colleagues.

<u>A</u> Type of Conflict	<u>B</u> Typical Fact Pattern	<u>C</u> Relevant Authorities ¹	<u>D</u> Observations
(10) CFTC Receiver's Law Firm Represents Various Affiliates of a Third-Party Defendant	As receiver, CFTC proposes a lawyer who is a partner in a respected law firm. The defendant in the CFTC enforcement case is a fraudulent commodity pool. Receiver's law firm represents various affiliates of Fund Services Corporation, an entity that provided significant transactional services as the Offshore Fund Administrator to the defendant and whose services were discussed in the CFTC complaint. The Receiver brought on action against the FCM for the pool. The FCM claimed against the Fund Services Corporation as a	<u>CFTC v. Paul M. Eustace, et al.</u> Civil Action No. 05-2973 (E. D. Penn. May 3, 2007) and <u>C. Clark Hodgson, Jr., Receiver v. Man Financial Inc., et al.</u> Civil Action No. 06-1944 (E. D. Penn. May 3, 2007).	The receiver is a fiduciary to the Court who is subject to a higher standard of conduct with respect to handling conflicts of interest than that applied to private attorneys: (a) must avoid even the <i>appearance</i> of possible impropriety, unfairness or partiality and (b) fully disclose to the Court the receiver's and his firm's prior relevant client relationships. In <u>Eustace</u> , relying on bankruptcy trustee case law and on the CFTC's position that the receiver should be replaced, the Court replaced the receiver with a new receiver <u>ad litem</u> for the portion of the litigation concerning the FCM. Lesson to be learned is that CFTC receivers should do a complete conflicts check and disclose to the Court and the CFTC even potential appearances of conflicts with respect to any actual named parties and with respect to entities that may be the subject of receivership actions. It may be very difficult for a large law firm that regularly represents the FCM brokerage community to take on a CFTC receivership that may involve potential claims by the receiver against an FCM or its affiliates, even where the FCM is not a named party to the action, without a conflicts approval from the appointing judge.

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	<p>third-party defendant.</p> <p>The receiver's law firm had undisclosed client relationships with numerous affiliates of the offshore Fund Administrator.</p>		
(11) In-House Law Firm Ethics Lawyer	Law firm designates an ethics lawyer to advise other lawyers in the firm.	ABA Opinion 08-453. Firm's ethics counsel represents the firm, not individual lawyers, and may be obligated to disclose the individual lawyer's ethical issue to the firm's management and possibly to outside authorities.	The appointment of in-house ethics counsel is an increasingly frequent occurrence. These types of issues are evolving but have not yet resulted in any court decisions.

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