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Ethical Issues for Lawyers Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Lawyer Representations Under the End-User Swap Exemption



BY MICHAEL SACKHEIM AND BARRY R. TEMKIN

This article considers professional responsibility and liability issues faced by lawyers who advise clients about or make representations in connection with the end-user exemption to the mandatory clearing requirement for swaps under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). These issues may arise when lawyers advise clients or others about or attest to the accuracy of client representations in filings with governmental agencies, swap data repositories (SDR), derivatives clearing organizations (DCO), or swap execution facilities (SEF). The ethical component of this article will be analyzed under the ABA Model Rules of Professional Conduct, and, in particular, Model Rule 2.3. In addition, we will consider exposure for professional liability which may be incurred by lawyers who are accused of providing incorrect information.

Dodd-Frank generally requires that swap transactions be cleared through a clearing facility unless an exemption applies. The “end-user clearing exception” applies to derivatives regulated by the Securities and Ex-

change Commission and Commodity Futures Trading Commission. As the Commodity Futures Trading Commission explains, “An end-user is a non-financial entity that is using swaps to hedge or mitigate its commercial risks.”¹

The provisions of Title VII of Dodd-Frank take place beginning in July 2011. Regulations promulgated under Title VII take effect 60 days after final publication.

Securities-Based Swaps

Under Dodd-Frank, some derivatives are subject to regulation by the SEC, and others by the CFTC. The CFTC regulates “swaps”, the SEC regulates “security-based swaps,” and the agencies jointly regulate “mixed swaps.” Dodd-Frank exempts a securities-based swap otherwise subject to mandatory clearing if: (1) one party to the securities-based swap is not a financial entity; (2) is using the security-based swap to hedge or mitigate commercial risk; and (3) notifies the SEC how it generally meets its financial obligations associated with entering into non-cleared security-based swaps. See Pub. L. 111-203 Section 763 (a) (adding Exchange Act Section 3C(g)). This exemption is designed to allow non-financial end-users that qualify to retain flexibility in their risk management activities. 75 Fed. Reg. 79,993 (Dec. 21, 2010).

In December 2010, the SEC published proposed new Rule 3Cg-1, “End-User Exception to Mandatory Clearing of Security-Based Swaps.” The proposed rule would require non-financial entities to notify the SEC every

¹ See Commodity Futures Trading Commission, Office of Public Affairs, Q & A- End-User Exception to Mandatory Clearing of Swaps [hereinafter “CFTC Q & A”], http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/eue_qa.pdf.

time the end-user exception is used.² The proposed rule further provides that “a counterparty to a security-based swap that invokes [the end-user exception] shall satisfy the requirements of [the Dodd-Frank Act] by delivering or causing to be delivered the following additional information to a registered security-based swap data repository:

(1) The identity of the counterparty relying on the clearing exception;

(2) Whether the counterparty invoking the clearing exception is a “financial entity” as defined in Section 3C(g)(3) of [the Exchange Act];

(3) Whether the counterparty invoking the clearing exception is a finance affiliate meeting the requirements described in § 3C(g)(4) of [the Exchange Act];

(4) Whether the security-based swap is used by the counterparty invoking the clearing exception to hedge or mitigate commercial risk as defined in [proposed Exchange Act Rule 3a67-4(a)];

(5) Whether the counterparty invoking the clearing exception generally expects to meet its financial obligations associated with the security-based swap by using any of the following:

(i) A written credit support agreement;

(ii) A written agreement to pledge or segregate assets;

(iii) A written third-party guarantee;

(iv) Solely the counterparty’s available financial resources; or

(v) Means other than those described in paragraphs (a)(5)(i), (ii), (iii) and (iv) of this section;

(6) Whether the counterparty invoking the clearing exception is an issuer of securities registered under Section 12 (15 U.S.C. 78l) or subject to reporting requirements pursuant to Section 15(d) (15 U.S.C. 78o(d)) of the Act, and if so:

(i) The relevant Commission Central Index Key number for the counterparty invoking the clearing exception; and

(ii) Whether an appropriate committee of the board of directors (or equivalent body) of the counterparty invoking the clearing exception has reviewed and approved the decision to enter into a security-based swap subject to the clearing exception.

(Proposed Rule § 240.3Cg-1, 75 Fed. Reg. 80011.)

The SEC has proposed that this information be reported through the same channels described by proposed Exchange Act Rule 901, which guides the party responsible for reporting the information to the SDR.³ According to this proposed rule, “with respect to a security-based swap in which only one counterparty is a security-based swap dealer or major security-based swap participant, the security-based swap dealer or major security-based swap participant shall be the reporting party.” Proposed Rule § 242.901(a)(i), 75 Fed. Reg. 75284 (Dec. 2, 2010). Any information reported should be communicated electronically “in a format required by the registered security-based data repository” Proposed Rule § 242.901(h), 75 Fed. Reg. 75285.

Swaps

The Commodity Futures Trading Commission is given new jurisdiction to regulate swaps under Dodd-

² 75 Fed. Reg. 79,994 (Dec. 21, 2010).

³ See 75 FR 75208 (Dec. 2, 2010).

Frank. Dodd-Frank repeals Section 2(h) of the Commodity Exchange Act, which exempted certain OTC transactions in non-agricultural energy products entered into by eligible contract participants or eligible commercial entities.⁴ The CEA generally requires, in section 2(h)(1), that swaps be cleared by a DCO. Section 2(h)(7) of the CEA provides that a swap may be exempted from mandatory clearing if one party to the swap: (1) is not a financial entity; (2) is using swaps to hedge or mitigate commercial risk; and (3) notifies the CFTC of how it generally meets its financial obligations in regards to swaps. Under the proposed CFTC regulations, one party to each exempted swap transaction must notify a SDR of certain information establishing the grounds of the end-user exemption. As was the case with security-based swaps, the required information includes which party is electing to use the end-user exception, whether the counterparty is a financial entity; whether the party is using the swap to hedge or mitigate risk; and, in some circumstances, approval of the party’s board of directors.⁵ The CFTC notes that the end-user’s required submission is fairly straightforward: “This notice is a user-friendly, check-the-box procedure spelled out in the rule.”⁶ Importantly, new section 9(a)(6) of the Commodity Exchange Act, added by Dodd-Frank, makes it a felony punishable by a fine of not more than \$1 million or imprisonment for not more than 10 years, or both, for “any person to abuse the end-user clearing exemption under section 2(h)(4) [“Prevention of Evasion”], as determined by the Commission.”

Professional Liability Considerations for Attorneys

Although swap exchanges are in their infancy and neither the SEC nor the CFTC have finalized their rules governing the end-user exception, analogous precedents provide some guidance to attorneys who advise end-user clients about swaps or make regulatory filings for end-users. These authorities reveal professional responsibility and professional liability guidelines and pitfalls for attorneys who advise clients about securities filings. Moreover, under some circumstances, lawyers may have professional liability to non-clients for their representations. Finally, lawyers must be mindful of conflicts among counterparties to a swap transaction, or between the lawyers’ own interests and those of their clients.

Lawyers have been prosecuted for omissions in filing statements. Consider the case of Don Hershman, an attorney in private practice who was recently prosecuted by and barred from appearing before the SEC for mis-

⁴ See, The Dodd-Frank Act’s Effect on Hedging Activities of Energy Companies and Large Energy Consumers, Sidley Austin LLP Energy Regulatory Update, July 29, 2010, http://www.sidley.com/files/News/aea79e50-1fa7-4851-a5cd-d98694a6ff20/Presentation/NewsAttachment/e8aad99a-7799-4039-8d82-e0c9e4c4398b/energy_regulatory_update_072910.pdf

⁵ See Proposed Rule, Commodity Futures Trading Commission, 17 CFR Part 39, 2010-31578, <http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2010-31578.html>

⁶ See CFTC Q & A, *supra* note 2.

representations in private placement memoranda.⁷ From 2005 to 2008, Hershman supervised the drafting of sixteen private placement memoranda for Wextrust Capital, LLC., which led to the raising of more than \$127 million in investments. In November 2007, Hershman discovered that Wextrust's Chief Financial Officer had been convicted for conspiracy to commit bank fraud four years earlier. Despite this knowledge, Hershman continued to prepare placement memoranda without disclosing the conviction. Several of those memoranda described the CFO as "a principal and integral part of the management team" and as the person who "brought focus and vision to the Manager's investment and merchant banking divisions," but none of them disclosed his conviction. Between the time Hershman discovered the truth about the conviction, in November 2007, and February of 2008, Hershman's law firm prepared offerings for Wextrust that helped it raise \$7.5 million from investors. This led to the SEC barring Hershman for life from appearing before the Commission.

A lawyer whose judgment is clouded by personal interests is likely to overlook important professional obligations. Moreover, there is precedent for imposing civil liability on lawyers whose representations are relied upon by others. In terms of professional liability to non-clients, the leading case of *Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood*⁸ acknowledged the possibility of attorney liability to a third party that was misled by the attorney's opinion letter. In that case, Prudential was notified by an insured that it was having difficulty meeting debt obligations. In agreeing to a debt restructuring, Prudential required an assurance from its insured's counsel, the defendant law firm. The law firm issued an opinion letter to Prudential assuring it that certain mortgage documents involved in the restructuring plan were "legal, valid, and binding" obligations of the insured. These documents were not prepared by the firm, but by other counsel, and after relying upon the opinion letter Prudential discovered that there was an error stated on one of the recorded documents. As a result, Prudential suffered significant losses when the insured filed for bankruptcy. Prudential then sued the insured's law firm on the theories of negligence and breach of contract to a third-party beneficiary.

After winning a summary judgment motion at the trial level and Prudential's subsequent appeal, the New York Court of Appeals affirmed the grant of summary judgment and held that the firm had not breached its duty of care to Prudential. However, in doing so, the court observed that in some circumstances a lawyer might owe a duty to non-clients. In so doing, the court rejected the law firm's argument that imposing such liability would thwart lawyers' ethical responsibilities to their own clients:

Initially, it must be stressed that attorneys, like other professionals, may be held liable for economic injury arising from negligent representation. . . . [W]here, as here, the negligent acts, i.e., the creation of an opinion letter and the transmission of that letter to a third party for the party's own use, were carried out by the lawyer at the client's express direction, the ethical consider-

ations of Canons 4 and 5 are insufficient reason to insulate attorneys from liability.⁹

In the Enron securities fraud litigation, the district court judge wrote, in denying summary judgment to Enron's outside corporate counsel, that:

professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely.¹⁰

Thus a lawyer who makes a representation which is relied upon by a non-client may be exposed to civil liability to that non-client who reasonably relies upon it to his detriment. In addition, the Rules of Professional Conduct address lawyer representations to non-clients in RPC 2.3, 4.1, and 8.4. The SEC Standards of Professional Conduct for Attorneys Representing Issuers obligate an attorney to report evidence of a material violation of the securities laws to the chief legal officer of a corporation, or to the board of directors or the audit committee.¹¹

Ethical Principles Involved in Lawyer Representations and Advice

In all likelihood, a lawyer subject to discipline by a federal regulatory agency will be also subject to reciprocal discipline by state attorney disciplinary authorities. The ABA Model Rules of Professional Conduct must accordingly be read in connection with federal regulatory obligations. Rule 2.3, Rule 3.3, Rule 4.1, and Rule 8.4, will each be considered in turn.

Rule 2.3 Evaluation For Use By Third Persons. ABA Model Rule of Professional Conduct 2.3 states:

(a) A lawyer may provide an evaluation of a matter affecting a client for the use of someone other than the client if the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client.

(b) When the lawyer knows or reasonably should know that the evaluation is likely to affect the client's interests materially and adversely, the lawyer shall not provide the evaluation unless the client gives informed consent.

(c) Except as disclosure is authorized in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by Rule 1.6.

This rule might be invoked if a lawyer advises a client about the applicability of the end-user exemption. To the extent that both parties to the swap transaction are relying on a single lawyer's opinion, the evaluation may be "for the use of someone other than the client" within the meaning of RPC 2.3. This could raise conflict of interest issues as well. There are other examples of evaluations made for the benefit of non-clients. For ex-

⁹ 80 N.Y.2d 377, http://neuro.law.cornell.edu/nyctap/search/display.html?terms=courts&url=/nyctap/192_0215.htm

¹⁰ *In re Enron Corp. Securities Derivative and ERISA Litigation*, 235 F. Supp. 2d 549 (S.D. Tex. 2002), *aff'd* 368 F.3d 501 (5th Cir. 2004).

¹¹ See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6,296.

⁷ *In the Matter of Don S. Hershman*, Adm. Pro. File No. 3-14218 (Feb. 2, 2011), available at <http://www.sec.gov/litigation/admin/2011/33-9180.pdf>.

⁸ 80 N.Y.2d 377 (1992).

ample, Rule 2.3 would be invoked by an opinion concerning the title of property rendered at the behest of a vendor for the information of a prospective purchaser, or at the behest of a borrower for the information of a prospective lender.¹² In some situations, the evaluation may be required by a government agency, such as an opinion concerning the legality of securities registered for sale under the securities laws.

Insurance defense lawyers are hired by carriers to defend policyholders. As part of their normal duties, defense counsel provide written evaluations to their employing carriers. In so doing, insurance defense counsel must be mindful of “tripartite” conflicts between the interests of the carrier and its insureds.¹³

When the evaluation is intended for the information or use of a third person, a legal duty to that person may arise. However, because such evaluations involve a departure from the normal client-lawyer relationship, the lawyer must be satisfied as a matter of professional judgment that making the evaluation is compatible with other functions undertaken on behalf of the client.

Lawyers who make representations to others in the course of their practices must also be mindful of RPC 4.1 and 8.4, which proscribe false statements. These rules provide as follows:

Rule 4.1 Truthfulness in Statements to Others. In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

Rule 8.4 Misconduct ABA Model Rule 8.4 provides that:

¹² The New York Rules of Professional Conduct, Oxford University Press (2010) at 419, 427.

¹³ See Barry R. Temkin, Coverage Conflicts for Retained Insurance Defense Counsel, 242 NYLJ (July 8, 2009), http://works.bepress.com/cgi/viewcontent.cgi?article=1016&context=barry_temkin.

It is professional misconduct for a lawyer to:

* * * * *

(c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation;

* * * * *

Thus, a lawyer who engages in factual misrepresentations may be subject to professional discipline, as well as civil liability.

Conclusion

Lawyers who advise clients about swaps and derivatives may take guidance from time-honored principles interpreting lawyers’ duties and obligations to clients they advise. In addition, lawyers should heed past precedents about civil liability to non-clients who may reasonably be affected by legal opinions and factual representations. Lawyers for end-users must be vigilant to guard against any attempts to evade or abuse the end-user clearing exemption. Finally, lawyers should be aware of the potential for professional discipline in the event of a violation of the Rules of Professional Conduct.

Barry R. Temkin is a partner at Mound Cotton Wollan & Greengrass, an adjunct Professor at Fordham University School of Law and Chair of the New York County Lawyers’ Association Professional Ethics Committee. Michael Sackheim is a partner at Sidley Austin LLP, managing editor of Futures and Derivatives Law Report (Thomson/West) and immediate past Chair of the New York City Bar Futures & Derivatives Regulation Committee. Kate E. DiGeronimo, an associate at Mound Cotton, assisted in the preparation of this article. This article is based on a paper presented at the 33rd Futures Industry Association Law and Compliance Division Conference on the Regulation of Futures, Derivatives and OTC Products. It is published with the permission of the FIA.