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SUMMARY OF FREEMAN, FREEMAN & SALZMAN, P.C. OPINION LETTER RE:

CME Rights to Reimbursement of Guaranty Payment under Proposed Cross-Margining Arrangement with the London Clearing House

The legal opinion concerns certain questions that arise from the proposed cross-margining arrangement proposed between the Chicago Mercantile Exchange ("CME"), London International Financial Futures & Options Exchange ("LIFFE"), and the London Clearing House ("LCH"). The proposed arrangement would operate in the following general manner.

Relevant Facts

CME clearing members that are also both LCH members and LIFFE clearing members or have affiliates that are both LCH members and LIFFE clearing members would be able to trade certain contracts at LIFFE, and participating LCH members and LIFFE clearing members would in turn be able to trade certain contracts at the CME. Such trading would be limited initially to proprietary trading. Unlike cross-margining with the Options Clearing Corporation ("OCC"), the performance bond and positions of participating clearing members would be held in separate accounts by the CME Clearing House and LCH. The performance bond and positions will not be held in a joint account. To protect each clearing organization from suffering losses from a default in connection with such cross-margin trading by a clearing member of the other clearing organization, the CME Clearing House and the LCH would provide each other with "cross-guaranties" in the amount of the applicable margin reduction. For example, the CME would guarantee payment of any net unpaid margin amounts owed by CME clearing members to the LCH, and the LCH would give the CME a similar cross-guaranty as to any net unpaid margin amounts owed by LIFFE clearing members to the CME. As part of this arrangement, each participating clearing member agrees that all of its positions, margin deposits, and other property in the possession or control of the CME would be subject to a security interest as set forth in the CME Rules and in the Cross-Margining Agreement. Once a guaranty payment is made, the clearing organization making the payment would be subrogated to the other clearing organization's claim against the defaulting clearing member and have a claim for reimbursement of the guaranty payment from that clearing member.

Legal Issues

The legal opinions concern the situation in which the CME has made a guaranty payment to the LCH, but the defaulting CME clearing member becomes insolvent, files a bankruptcy petition, and therefore does not reimburse the CME. The CME would seek to satisfy its reimbursement claim by applying the performance bond and other security that it holds from the defaulting clearing member to repay the debt. The insolvent clearing member's bankruptcy trustee or the clearing member itself as a Chapter 11 debtor-in-possession may oppose the CME's effort to satisfy its reimbursement claim in that manner.

The three questions addressed in the legal opinion are:

First, would the CME's attempt to satisfy its reimbursement claim against the defaulting clearing member be subject to the automatic stay provided by 11 U.S.C. § 362(a)?

Second, if the automatic stay does apply, would the CME be entitled to a lifting of the stay so that it can satisfy its reimbursement claim from the defaulting clearing member's security in the CME's control?

Third, what are the governing legal rules with respect to bankruptcy jurisdiction, venue, and choice of law when a CME clearing member defaults in this international context?

Summary of Legal Opinion

(1) The question whether the CME may take advantage of the exemption from the automatic stay under 11 U.S.C. § 362(b)(6) that would normally apply when a CME clearing member becomes bankrupt is not clearly answered by the Bankruptcy Code. The uncertainty arises because the transactions giving rise to the CME's claim will take place at LIFFE, not a contract market designated by the CFTC. The exemption would otherwise apply because the CME's claim for reimbursement of its guaranty payment to the LCH would be considered a "margin payment" as that term is defined for purposes of applying § 362(b)(6) and the CME's claim would be considered "pre-petition." Although the ambiguities in the Bankruptcy Code on this issue create doubt as to how the courts will resolve the issue, the strong public policy expressed in the relevant legislative history of preventing a chain reaction of trading failures because of one firm's insolvency should ultimately prevail over the general policies behind the automatic stay.

(2) In any event, the CME should have the right to satisfy its claim against the defaulting clearing member's performance bond and other posted security within the CME's control because that property should not be considered to be within the bankruptcy estate.

(3) The CME also appears to have an immediate recoupment right that it could use to satisfy its claim without violating the automatic stay.

(4) Even if the CME does not have the right to take immediate action against the defaulting clearing member's security because of the automatic stay, the CME should be able to "freeze" that security while it prepares and files a motion to enforce its rights (including the lifting of the automatic stay to allow a setoff of the CME's reimbursement claim or, alternatively, satisfaction of the CME's perfected security interest against the clearing member's security). Given the strength of the CME's setoff rights and its perfected security interest in the defaulting clearing member's security, the CME would be entitled, under all the circumstances, to a lifting of the automatic stay to enable the CME to obtain payment of the clearing member's guaranty reimbursement obligation.

(5) Because the insolvency of a CME clearing member participating in the cross-margining arrangement would likely have an impact in both the United States and England, it must be expected that bankruptcy proceedings will be initiated in both countries. In recent years, procedures and legal principles have been developed allowing American and English courts to cooperate in administering such bankruptcies efficiently and fairly in an effort to avoid conflicting decisions and duplicative proceedings. Although the American bankruptcy court must assure itself that American creditors are being fairly treated, it will defer to the English courts if the issues have a stronger connection to England. Similarly, the English courts will likely defer reciprocally to the American bankruptcy proceedings if the defaulting clearing member is an American corporation managed in this country.