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Sears Roebuck Acceptance Corp. (SRAC)

Do the DC Rules permit the modification of the CDS Auction Settlement Terms for Sears Roebuck Acceptance Corp. to prevent a market participant from creating an Open Interest to buy exceeding the face amount of all Deliverable Obligations not otherwise owned or controlled by that market participant?

Should the CDS Auction Settlement Terms expand the list of deliverable obligations?

The Americas Determinations Committee (**DC**) is to meet again on January 3, 2019 to consider three general interest questions previously submitted in relation to the Auction arrangements for SRAC. Those submissions ask the DC to consider, among other things:

(i) restricting the Physical Settlement Requests that a market participant and its affiliates can submit (beyond the restrictions that would already apply on any normal Auction Settlement Terms, which restrict such Physical Settlement Requests to the size of the CDS position held) (this is Issue 2018121801);

(ii) adding the Second Lien notes guaranteed by SRAC to the Deliverable Obligations on the Final List, even though the guarantee does not satisfy the requirements of the Standard North American Corporate (**SNAC**) CDS (which is the form of CDS applicable to standard CDS referencing SRAC) (this is Issue 2018122001); and

(iii) adding the Second Lien Alternative Tranche Loans guaranteed by SRAC to the Deliverable Obligations on the Final List, even though the guarantee does not satisfy the SNAC requirements (this is Issue 2018122101).

For the purposes of this submission, "**relevant amendments**" refers to any amendment to impose restrictions on the quantum of Physical Settlement Requests (beyond the restrictions that would standardly apply) and to any amendment to the Final List to add an instrument that would not satisfy the standard requirements for Guarantees under SNAC CDS.

The particular issues raised to the DC for consideration and determination arise from the risk that a market participant may be in a position to create an Open Interest to buy (for the purposes of the physical delivery/settlement arrangements forming part of the standard Auction settlement mechanics) which exceeds the amount of the Deliverable Obligations generally available to other market participants.

Summary

In summary, the DC should not make amendments outside the terms of the mandate contained in Section 3.2(d) of the DC Rules, the DC should not retrospectively amend the terms of existing SNAC CDS contracts by adding other instruments to the Final List which do not satisfy the contractual requirements of such SNAC CDS contracts and the DC should not consider that there is a mischief for the DC to counter in circumstances where the standard Auction settlement arrangements make specific provision for situations in which an Open Interest to buy cannot be completely covered by the Deliverable Obligations offered for sale.

Ability of the DC to make the amendments sought

Section 3.2(d) of the DC Rules provides an ability for the DC to make amendments to the Auction Settlement Terms or the Final List in limited circumstances. The second paragraph provides as follows:

"If the Convened DC determines that the Credit Derivatives Auction Settlement Terms and Final List are not broadly reflective of the Deliverable Obligations and ability to settle which would have been available if Physical Settlement had been the applicable Settlement Method and that this would cause prejudice to either Buyer or Seller under a Relevant Transaction, it may Resolve by Supermajority to make amendments to the Credit Derivatives Auction Settlement Terms and/or Final List as applicable in an attempt to avoid or mitigate against such prejudice."

Where the Auction Settlement Terms and Final List are broadly reflective of the Deliverable Obligations and ability to settle that would have applied if Physical Settlement had been applicable, then the DC has no mandate under this provision to make the relevant amendments. The concerns which the relevant amendments would seek to address appear to be exactly those that would arise if Physical Settlement were applicable: that is, the risks of a "short squeeze" in the physical settlement side of the Auction arrangements are none other than the risks which would arise in Physical Settlement of CDS transactions on SRAC outside the Auction arrangements, if Physical Settlement were applicable.

It should be noted that the standard Auction Settlement Terms provide directly for circumstances where the Open Interest to buy exceeds the offers to sell: in these circumstances, the Final Price for CDS Auction Settlement will go to 100%. There is always a risk of a 100% Auction Final Price on any CDS Auction where there is an Open Interest to buy, as the Final Price is determined by the price at which the last portion of that Open Interest is satisfied, if at all. These are the very circumstances which are said to be likely to arise in the SRAC situation. It is inappropriate for any amendment to be made to the Auction Settlement Terms or the Final List to negate the operation of a provision of the standard Auction arrangements which contractually addresses the issue. Neither party to a SNAC CDS on SRAC can be truly prejudiced by an outcome that was both known to be a real possibility and for which the standard Auction arrangements make provision.

What is the expectation of CDS market participants?

Eligible Market Participants are all sophisticated. The general expectation of those participants and of the wider investment market are that contractual arrangements are binding and not subject to sweeping amendment made by a third party without a mandate to do so. It is clear from commentary in the market over a number of years that there has always been a risk of the Deliverable Obligations for SRAC being insufficient to satisfy the physical settlement requests of CDS Sellers. The risk could materialise in a number of different ways: relevant instruments could be held within the Sears group and not made available to the market; relevant instruments could be (and apparently in the past have been) redeemed or refinanced with instruments that are not Deliverable Obligations; available Deliverable Obligations could be bought up by one or more participants who wish not to make them available in the market. There are no doubt other possibilities.

Against this is an ever present moral hazard risk in the CDS market: the risk that a CDS Buyer may organise its affairs so as to increase the likelihood of the occurrence of a credit event and/or decrease the Final Price in the Auction (so as to increase its own recovery under bought CDS) and that a CDS Seller would seek to reduce the likelihood of a credit event and/or increase the Final Price in the Auction (so as to reduce its own losses under sold CDS). All market participants are aware of this risk.

Who will be aggrieved by the current risks?

Any CDS Buyer who holds a deliverable obligation or a matched CDS Seller position (i.e. either a creditor of SRAC under a relevant instrument or a market intermediary) will have no issues with a "short squeeze". Indeed any investor holding a Deliverable Obligation without a CDS hedge will be delighted by a short squeeze, as it will be able to sell out at the high Auction Final Price.

The issues which have been raised particularly affect those CDS Buyers who do not have an equivalent exposure to SRAC, whether directly or through sold CDS.

It is clear that the Auction arrangements seek to establish a market price for the Deliverable Obligations. The market price is the market price within the confines of the Auction structure – it is not the market price more generally. While that market price may be informed by the wider creditor expectation of recovery in the insolvency/bankruptcy processes under way, that market price is also informed by other important factors, including critically the availability of and liquidity in the Deliverable Obligations. The principle of the Auction process is that the CDS market price is driven by market forces within the confines of the Auction structure. The contractual principle of Auction Settlement (as incorporated into standard CDS Contracts) is that the parties to those contracts have pre-agreed that the market price as determined by the Auction process is the price at which the CDS Contracts will settle and it is clear (see notes above) that the standard Auction processes envisage situations where the Auction Final Price will be 100%, irrespective of the credit quality of the underlying debtor(s).

That market price has in the past shown anomalies: in particular the auction for Freddie Mac yielded a significantly higher price for the subordinated debt than for the senior debt. But this is no reason for the DC to amend the Auction arrangements to provide for a new or different set of Auction Settlement Terms/Final List in order to alter the price at which Auction Settled CDS Contracts will settle.

Adding ineligible instruments to the Final List

The DC should in any event not add ineligible instruments to the Final List. While there may well be arguments, in relation to the Second Lien and Second Lien Alternative Tranche Loans guaranteed by SRAC, that these instruments represent the same or a similar credit risk (in terms of recovery in the Chapter 11 processes) as the Deliverable Obligations and should therefore not have a lower recovery in those processes, the facts remain that the SNAC CDS contract does not accept these instruments as Deliverable Obligations and, in the CDS market, this may well lead to different outcomes in relation to these different instruments. SNAC CDS on SRAC have all been priced, when entered into and terminated, by reference to the particular instruments available as Deliverable Obligations. It is not appropriate for the DC now, in effect, to change the definition of Deliverable Obligation: this is not the basis on which parties to SNAC CDS entered into their respective bargains. With a broader set of Deliverable Obligations, the pricing for entering into/terminating such SNAC CDS would inevitably have been different and it is likely that in a number of cases the parties to a CDS transaction would not have contracted in the first place. The DC will not be in a position to assess what compensation should be awarded to those CDS Sellers (of whom there may be many) whose contractual rights would thus be altered or to assess how to deal with those market participants who would not have entered into such CDS contracts at all. And without compensation, this would be a highly inequitable approach for the DC to take.

The credibility of the DC

The credibility of the DC is likely to be significantly harmed if it makes retrospective amendments to standard CDS contracts. It is for the DC to organise and implement Auction settlement arrangements in accordance with the standard processes, subject to the limited exceptions allowed for in Section 3.2(d) of the DC Rules.

We consent to a copy of this statement being provided to the members of the Americas DC considering the issues in relation to SRAC CDS and to any members of any Credit Derivatives Determinations Committee convened under the DC Rules in connection with the issues discussed herein. We consent to a copy of this statement being made publicly available on the ISDA Credit Derivatives Determinations Committee website. This statement does not constitute legal advice.