MILBANK, TWEED, HADLEY & McCLOY LLP

MEMORANDUM

TO: DC Secretary

FROM: John R. Williams
Ben Kastner

DATE: January 2, 2019

RE: Issue Numbers: 2018121801, 2018122001 and 2018122101 (Questions related to the Auction Settlement Terms in respect of Sears Roebuck Acceptance Corporation)

Should the CDS Auction Settlement Terms for Sears Roebuck Acceptance Corp. be modified to impose - retrospectively - position limits on a market participant's ability to rely on the Auction to settle its outstanding CDS contracts by way of physical settlement?

Should the Determinations Committee revise - retrospectively - the terms of existing CDS Contracts to permit obligations that do not qualify as Deliverable Obligations to be admitted to the Final List?

We refer to (x) the Credit Derivatives Determinations Committee's (the "**DC**") decision on December 20, 2018 to accept for consideration the question as to whether the CDS Auction Settlement Terms for Sears Roebuck Acceptance Corp. ("**SRAC**") should be modified 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 (Issue Number: 2018121801), (y) the DC's decision on December 24, 2018 to accept for consideration a request posted to the DC that it add the second-lien senior notes issued by Sears Holding Corp. and guaranteed by SRAC (CUSIP 812350AE6) to the Final List (Issue Number: 2018122001) and (z) the DC's decision on December 24, 2018 to accept for consideration a request submitted on December 24, 2018 to add the second-lien Alternative Tranche Line of Credit Loans issued by Sears Holding Corp. and guaranteed by SRAC to the Final List (Issue Number 2018122101) (the submissions described in clauses (x), (y) and (z) above, the "**Auction Rule-Revision Requests**"). Capitalized terms used but not defined herein shall have the meanings set forth in the 2014 ISDA Credit Derivatives Definitions (the "**Definitions**"), or otherwise in the 2018 ISDA Credit Derivatives Determinations Committee Rules (September 28, 2018 version) (the "**DC Rules**").

We make this submission to the DC on behalf of Cyrus Capital Partners, LP ("**Cyrus**").[1]

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[1] We note, however, that, in keeping with Cyrus' information barrier policies, we have not been in contact with Cyrus' representative on the DC regarding this submission or any other matter under consideration by the DC in respect of SRAC.

Summary

We believe that the DC should reject all of the Auction Rule-Revision Requests[2] because each of them amounts to a retrospective revision of fundamental contractual rights, duly bargained for in good faith by diligent market participants under transparent and predictable rules.

- Granting any of the Auction Rule-Revision Requests would irreparably damage the market for CDS transactions, as it would signal that any material term of a CDS contract could be revised after the fact to accommodate the special pleadings of one side of the contract or the other.

- Contrary to the interpretation offered by the submitters of the first two Auction Rule-Revision Requests, the language of Section 3.2(d) of the DC Rules actually *supports* the conclusion that the Auction Settlement Terms already function as intended, as they would deliver the same outcome that would be produced if Physical Settlement were the Settlement Method under the contract[3] (even assuming, for the sake of argument, that the technical market dynamics described by the submitters with respect to the Deliverable Obligations of SRAC actually come to pass).

- The proposals to add to the Final List obligations of Sears Holding Company guaranteed by SRAC are in fact beyond the authority of the DC to implement, as they amount to changes to the explicit terms of existing contracts – the sort of change that would require explicit consent by all relevant parties by way of a protocol or similar amendment procedure.

- Finally, the DC (and other market participants) should recognize that the fears that the submitters raise about the Auction possibly settling at par are specific to this particular Credit Event and the technical issues affecting SRAC Obligations in the bankruptcy process and therefore do not reflect a structural flaw in the CDS contract that should be of concern to the CDS market more broadly.

The submitters of the Auction-Revision Requests argue that making the requested revisions would protect the "reliability and fairness of the CDS Auction settlement process," but we are confident that DC Members understand very well that granting these requests would have exactly the opposite effect on the CDS market.

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[2] We do not intend this submission to refer to the question relating to the decomposition of index transaction, which we do not see as an issue to be decided by the DC.

[3] Section 3.2(d) of the DC Rules provides in relevant part that "[i]f 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."

Expected SRAC Auction Outcomes

We agree with the submitter of Issue 2018121801 that in a circumstance in which (a) net Sellers of CDS protection submit more Physical Settlement Buy Requests than net Buyers of protection submit Physical Settlement Sell Requests, the Auction will result in a net Open Interest to Buy Obligations and (b) if the size of that Open Interest exceeds the supply of Obligations that owners of Deliverable Obligations are willing to sell at prices below par, the Auction Final Price will be 100%. We also agree that if there is a CDS Seller whose net position exceeds the supply of Deliverable Obligations not already owned by that Seller or its affiliates, and that Seller wants to acquire more Obligations, it may turn out, ***depending upon what actions other holders of the Deliverable Obligations take***, that the Seller could submit a large enough Physical Settlement Buy Request to cause the Auction to settle at par.

We do not agree, however, that this means the DC must change the rules of the Auction retrospectively.

1. Submitters argue that the Auction Settlement Terms should be changed because when they are applied to the technical realities of the market for SRAC obligations, they may result in a settlement price for CDS contracts that is not consistent with recoveries on SRAC's obligations generally. We note first that at present it is uncertain whether the technical market dynamics that the submitter predicts will in fact occur, since that will depend on the actual availability of Deliverable Obligations, which in turn depends upon the behavior of independent market actors. Second, and more importantly, the fact that a CDS Auction may result in a Final Price that is different from recoveries on the Reference Entity's Obligations generally does not mean that the outcome is unintended under the contract or commercially unreasonable. As the members of the DC well understand, the CDS contract is a technical financial instrument whose performance is dictated by its precise terms and the specific terms of the instruments it references, rather than a generic measure of predicted recoveries in a bankruptcy proceeding. The fact that CDS settlement prices differ from generic recovery levels is nothing new and has never been cause for a revision of the contract, let alone a retroactive one.

2. Furthermore, even if the circumstances described by the submitters come to pass, the CDS contract will work as expected for each and every Buyer that has hedged itself by holding or acquiring Deliverable Obligations, since such a Buyer will be able to receive the full face value of the outstanding principal balance of those Obligations, as has always been the case. Unhedged protection Buyers are of course exposed to the technical dynamics of the Auction and the market for Deliverable Obligations, but this has always been recognized as a key risk of being a "naked short," i.e., an unhedged Buyer of CDS.

3. Indeed, the fact that market participants on both sides of the market can agree on how the Auction rules will work given a particular set of factual assumptions demonstrates that participants in the CDS market take such factors into account at the time they entered into the relevant contracts in the first place. This is why all prudent protection Buyers consider the possibility of their CDS contracts being "orphaned" due to the possibility of Deliverable Obligations being redeemed and not replaced. The DC members therefore can safely assume that such common knowledge had an impact on the upfront price agreed to between Buyers and Sellers when the relevant contracts were executed.

4. In fact, with respect to SRAC specifically, market participants have been on notice for several years that CDS contracts might have their recoveries affected by the limited supply of Deliverable Obligations. Following are just a few pointed excerpts from widely available analyst reports dating back several years:

    a. April 21, 2011 Barclays Analyst Report: "Sears Roebuck (SRAC) CDS will continue to benefit technically from the ***dearth of deliverables***, which we think will decline further over time (note, the Sears Senior Secured bonds are not deliverable into SRAC CDS)."

    b. January 23, 2012 & January 30, 2012 Barclays Analyst Reports: "We continue to think that ***SRAC CDS is an inferior instrument to translate a credit view in [Sears Holdings], given that*** 1) it sits at a subsidiary of Sears, Roebuck, & Co, which in turn is a subsidiary of Sears Holdings Corporation; and 2) ***lack of deliverables (Senior Secured Notes are NOT deliverable into SRAC CDS; per the company ~$300mn bonds outstanding will be outstanding at FY12- end***)."

    c. September 23, 2013 J.P. Morgan Analyst Report: "When looking at recovery for the [SRAC] CDS, it is important to consider that if SRAC or SHLD were to file for bankruptcy, there is ***only <$327 million of deliverable debt.*** There would likely be a large technical move to account for the mismatch between debt and CDS contracts ***so recovery value may not dictate the price where the CDS will trade upon a filing***."

    d. January 10, 2014 J.P. Morgan Analyst Report: "Only SRAC debt is deliverable into CDS. We do not anticipate that Sears will issue additional debt at SRAC, but we also don't expect it to pay down its existing SRAC debt until maturity (some as late as 2043). ***This debt is not liquid, no issue is over $100 million, and it makes the technicals odd for the CDS***."

    e. April 1, 2015 Barclays Analyst Report: "We think CDS can continue to grind tighter, given the lack of deliverables . . ."

Given the clarity of the CDS Auction rules on this point, and the extent of public comment specifically on the scarcity of the SRAC Deliverable Obligations, the DC should assume that market participants took such facts into account when pricing the CDS contracts they entered into over the last few years. Neither Buyers nor Sellers of SRAC CDS can be said to be prejudiced by an outcome that both could see as a possibility when they entered into the contract in the first place. Upsetting these settled expectations long after these transactions have been priced and traded would be highly prejudicial to protection Sellers in this case specifically and highly worrying for all CDS market participants generally.

Application of Section 3.2(d) of the DC Rules

The submitters are also incorrect in their application of Section 3.2(d) of the DC Rules to this situation. Submitters argue that the second paragraph of that section gives the DC the authority to re-write the Auction Settlement Terms to protect naked protection Buyers. In fact, it does the opposite. The provision in question specifically authorizes only those changes that would cause the Auction Settlement Terms to deliver a set of rights and obligations for Buyers and Sellers who elect Physical Settlement in the transactions that arise in the CDS Auction that would conform, as much as possible, with the rights and obligations that would have applied had they relied on Physical Settlement directly. Because a physically settled CDS contract requires the Buyer to Deliver a Deliverable Obligation in order to receive

payment from the Seller, a Buyer that cannot Deliver a Deliverable Obligation would effectively see its CDS contract settle with a Final Price of par. In fact, then, the Auction Settlement Terms are already correct on this measure, as the same economic result will effectively occur for a naked Buyer in the Auction. To the extent Section 3.2(d) is applied, then, it would only reinforce the proposition that the Auction Settlement Terms should remain as they have always been on this point.

Consideration of additional Deliverable Obligations

Two of the submitters have also seized on the predictions of the limited supply of Deliverable Obligations to request that the DC change the rules retroactively regarding which types of guarantees should be considered Deliverable Obligations in the Auction. The submitters are of course correct that *other versions* of the standard CDS contract (such as the version referencing European Corporates) include a wider range of guarantees as potentially Deliverable Obligations. However, as the submitters themselves acknowledge, it is well understood by all market participants that the additional guarantees they mention do not qualify as Deliverable Obligations under the terms of the Standard North American Contract, of which the SRAC CDS contract is one example. In fact, we believe, and we expect DC members would agree, that the contractual framework under which the DC is created does not grant the DC to power to make a revision of this sort. Such a fundamental change could only be effected by way of explicit contractual agreement among the parties (for example, by way of protocol). While it might be worthwhile for ISDA and relevant dealers to consider trading a revised form of the Standard North American Contract *going forward*, we expect the DC Members would all agree that (even if it were possible) it would be grossly unfair to market participants to change the terms of these contracts after the fact.

Implications for the CDS product generally

Representatives of other market participants have stated publicly that the technical issues related to settlement of the SRAC Auction should be of equal concern to market participants as the issues of potential manipulation through manufactured events being addressed by ISDA's Working Group on Narrowly-Tailored Credit Events (the "WG on NTCEs").[4] To the extent DC members wish to weigh such concerns, we believe they should understand that there are important differences between the concerns being addressed by the WG on NTCEs and the technical market dynamics resulting from known market conditions that may affect the SRAC Auction. Issues related to the narrow tailoring of Credit Events of the sort that arose in connection with Hovnanian are, and should be, of concern to the market generally because they can potentially arise in connection with any Reference Entity and therefore potentially affect *all* CDS contracts. By contrast, the issues playing out with respect to SRAC CDS contracts are specific to the mix of credit instruments actually issued by SRAC. In other words, they are the sort of credit-specific facts that prudent CDS traders and distressed debt analysts are expected to study and consider when entering into or valuing CDS contracts on a specific entity. On the other hand, the Hovnanian-style manufacturing of narrowly-tailored Credit Events is concerning precisely because it distorts many of the normal commercial incentives that credit analysts can reasonably expect Reference Entities to respond to. Such manufacturing therefore undermines good credit analysis. In the case of SRAC, as noted earlier, all market participants were aware of these technical dynamics and the resulting risks of unhedged positions.

[4] Bloomberg Daybreak: Americas, *The Battle Over Sears' Debt Heats Up*, Bloomberg (Dec. 28, 2018, 7:23 AM), https://www.bloomberg.com/news/videos/2018-12-28/the-market-for-sears-cds-is-broken-video.

For the DC to revise the rules of the SRAC auction at this point would be to undermine the effect of good credit analysis in roughly the same way that narrowly-tailored Credit Events do.

We confirm that a copy of this memorandum may be provided for information purposes only to the members of the DC convened under the DC Rules in connection with the Auction Rule-Revision Requests, and that it may be made publicly available on the DC website. We accept no responsibility or legal liability in relation to its contents.