

*Should the CDS Auction Settlement Terms for Sears Roebuck Acceptance Corp. be modified, as allowed by the DC Rules, 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?*

*In such a case, should the CDS Auction Settlement Terms limit the aggregate Physical Settlement Requests that any given market participant and its affiliates can submit at some lower amount than the face amount of all Deliverable Obligations not otherwise owned or controlled by that market participant in order to prevent any undue interference with the well-functioning, reliability, and fairness of the CDS auction settlement process?*

Capitalized terms used but not otherwise defined herein shall have the meanings assigned to them in the 2014 Credit Derivatives Definitions or the Credit Derivatives Auction Settlement Terms, as applicable.

### **Summary**

One entity reportedly controls the majority of Sears Roebuck Acceptance Corp (“**SRAC**”) Deliverable Obligations.<sup>1</sup> This same entity is reported to have sold a significant amount of CDS protection on SRAC.<sup>2</sup> If this entity creates an Open Interest to buy that is larger than the amount of Deliverable Obligations available to the market (outstanding Deliverable Obligations less Deliverable Obligations controlled by the entity creating the Open Interest to Buy), the CDS Auction Final Price will be 100, unless the entity effectively sells bonds to itself in the Subsequent Bidding Period. A 100 outcome does not represent the creditworthiness of the Reference Entity: bonds guaranteed by the Reference Entity that are not Deliverable Obligations are currently worth 25/100. Such a result would likely prejudice the vast majority of market participants who rely on the CDS auction to cash settle their trades at a price reflecting economic reality. **The DC has the ability under Section 3.2(d) of the DC Rules and should exercise its discretion to prevent the prejudice that would be created by this unfair and commercially unreasonable outcome.**

### **Facts and CDS Auction Failure to Produce a Commercially Reasonable Result**

As has been widely publicized,<sup>3</sup> of all outstanding SRAC Deliverable Obligations (“**Outstanding Deliverable Obligations**”) currently on the Supplemental List of Deliverable Obligations, the vast majority (“**Unavailable Deliverable Obligations**”) are owned or otherwise directly or indirectly controlled by one single market participant, with only a small fraction (“**Available Deliverable Obligations**”) being held or otherwise freely accessible or purchasable by the remainder of market participants. That controlling market participant (the “**Single Net**”

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<sup>1</sup> *In re Sears Holding Corporation, et al.*, Case No. 18-23538-RDD (Bankr. S.D.N.Y. 2018), Docket No. 1077.; <https://www.bloomberg.com/opinion/articles/2018-12-13/credit-default-swaps-get-weird-after-sears-bankruptcy>; <https://www.forbes.com/sites/bartchilton/2018/12/05/sears-death-gives-life-to-crisis-era-derivatives-demons/#492248b55dd6>

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

**Protection Seller**”) has also been reported to be a very significant net CDS protection seller of SRAC.<sup>4</sup>

Public Sources have indeed identified that a Single Net Protection Seller “*has gone to extraordinary lengths to exclude a chunk of Sears inter-company notes from an upcoming ISDA auction set to determine the payments that protection holders receive . . . [and] cut deals that prevent the Sears bankruptcy estate from selling any more of this otherwise-worthless internal debt to market participants in need of valid [Deliverable Obligations] for the ISDA auction process*” and that “*locking up the inter-company notes may help [Single Net Protection Seller] avoid CDS payouts*” (see Forbes article).

If, as part of the CDS auction, the Single Net Protection Seller submits a Customer Physical Settlement Buy Request that is larger than the outstanding principal balance of Available Deliverable Obligations, by definition those Available Deliverable Obligations will not be sufficient, in the second stage of the CDS auction (the *Subsequent Bidding Period*), to fill the entire net Open Interest to buy created as a result.

In that case, the CDS auction would essentially operate as follows (in plain English terms):

- In the first stage of the CDS auction, CDS market participants with net CDS positions establish demand to physical settle (i.e. trade) the Deliverable Obligations by submitting buy or sell physical settlement requests. Such requests only specify a quantity (of Deliverable Obligations) that such market participants elect to buy (for net CDS protection sellers) or sell (for net CDS protection buyers), without specifying any price. An initial starting price is also established by averaging certain quotations provided by the dealers participating in the CDS auction.
- A large buy physical settlement request submitted by a net CDS protection seller would create a net Open Interest to buy Deliverable Obligations in the CDS auction.<sup>5</sup>
- In the second stage of the CDS auction, the net Open Interest to buy is typically filled by any market participant electing to sell Deliverable Obligations and the price associated with the sell order clearing the net Open Interest to buy constitutes the CDS auction final price.
- **However**, where, as in the case in SRAC, the amount of Available Deliverable Obligations is less than the net Open Interest to buy (that could be created by the Single Net Protection Seller), the net Open Interest to buy will not be filled and, in that case, Section 12(e) of the CDS Auction Settlement Terms provides that the final price for purposes of settling the CDS contracts will be 100. As a result, no payment will be owed

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<sup>4</sup> Ibid.

<sup>5</sup> This assumes that the buy physical settlement requests exceed the sell physical settlement requests, which is expected to be the case in the SRAC CDS auction because of the small amount of Available Deliverable Obligations held by CDS protection buyers and the inability of CDS protection buyers to source any additional Deliverable Obligations.

by the Single Net Protection Seller (and for that matter, any other CDS protection sellers) on account of their CDS contracts.

- This outcome does not reflect the creditworthiness of the Reference Entity: the company's second lien notes (CUSIP 812350AE6), which are guaranteed by the Reference Entity but are not SRAC Deliverable Obligations, are currently worth ~25/100. It is mathematically impossible for these bonds to recover less than the SRAC Deliverable Obligations given that they are guaranteed by SRAC. These second lien notes therefore reflect a maximum recovery value for SRAC claims (given that they are issued by Sears Holdings Corporation and are guaranteed by a collection of subsidiaries, including SRAC), and illustrate that SRAC Deliverable Obligations, which trade at a nearly 50 cent premium, currently have an artificially high price caused by the market's anticipation and expectation of a disrupted and squeezed CDS auction. A CDS auction outcome where no payment is the end result but the market-implied price of credit is 75 points of payment (25 points of recovery) would negatively impact the efficiency, reliability, and fairness of the overall CDS market.

As a result, the purpose of the CDS auction, which ultimately is to establish, via a fair market process, the economic value of the lowest value claim (the "cheapest Deliverable Obligation to deliver") against SRAC according to basic principles of supply and demand in a competitive market, would be entirely defeated.

### **The DC has the Ability to and should Take Anticipatory Corrective Action as per the DC Rules**

Pursuant to Section 3.2(d) of the DC Rules, the DC is allowed to make changes to the CDS Auction Settlement Terms 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**. Such amendment may only be made after a public comment period unless the Convened DC Resolves by a Supermajority to allow such amendment without a public comment period." (emphasis added)*

All those conditions are satisfied here, as follows:

- Through physical settlement, a CDS protection buyer would deliver the Deliverable Obligations and receive par. Assuming the Deliverable Obligations are worth an equivalent amount to the SRAC-guaranteed but non-deliverable securities - around 25 cents on the dollar - this reflects a theoretical payment of around 75 cents of each dollar of CDS protection.

- If the auction is disrupted in the manner set out above, the CDS protection buyer would receive nothing on its CDS trade.
- This is clearly prejudicial to a CDS protection buyer as auction settlement would result in a loss of around 75 cents on the dollar on the CDS trade compared to the recovery that would be available through physical settlement.

In order to mitigate against this undue prejudice and to safeguard the integrity of the auction, the DC should make amendments to the CDS Auction Settlement Terms to ensure that the net Open Interest is reflective of a *bona fide* intention to physically settle and not artificially inflated by a market participant who knows that its buy request will be impossible to fill and thus may not possibly intend to physically settle.

### **Possible Amendments to CDS Auction Settlement Terms**

Possible amendments to the CDS Auction Settlement Terms that the DC should consider include establishing a cap on the size of the Customer Physical Settlement Request certain CDS market participants may submit. Under such cap, any market participant controlling more than a threshold amount (e.g. 20%) of all the Outstanding Deliverable Obligations would be prevented from submitting a buy physical settlement request for more than a certain amount (e.g. 25% in the aggregate) of Available Deliverable Obligations.

Because limiting non-*bona fide* orders likely to adversely impact the proper functioning of the CDS auction would receive wide-ranging support and because there is a limited amount of time before the SRAC CDS auction is expected to take place we do not believe opening a comment period on this issue as per Section 3.2(d) of the DC Rules is either necessary or appropriate and the DC should proceed with the necessary amendments without seeking public comments as allowed under Section 3.2(d).

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We confirm that a copy of this statement may be provided to the members of any Credit Derivatives Determinations Committee convened under the DC Rules in connection with the General Interest Question to consider the issues discussed herein, and that it may be made publicly available on the ISDA Credit Derivatives Determinations Committee website. We accept no responsibility or legal liability in relation to its contents.