SEARS ROEBUCK ACCEPTANCE CORP – EXTERNAL REVIEW

Argument in Support of the "No" Position.

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The Sears Loans Contain Two Additional Restrictions

1. **Party Restriction**: "a commercial bank or any other Person engaged in the business of making asset based or commercial loans, or any fund or other Person (other than a natural Person) that invests in loans."

2. **Capital Restriction**: " . . . has a combined capital and surplus in excess of $300,000,000 and which bank, Person or fund is approved by the Agent…."

The “Yes” Position Improperly Construes Plain Meaning

Citing *Stewart*, the “Yes” Position argues “capable of” means only “a practical possibility” or “the potential for.” (Yes Br., at 6).

- **<u>This is incorrect</u>**:
  - *Stewart* involved a federal maritime statute, *not* a contract governed by New York law.
  - Under the Second Interpretation, the Consent Required Loan provision is satisfied if the Loan is “capable of being” transferred to only a single person. This would make the Consent Required Loan provision obsolete and of little value to a CDS Seller.
  - Eight years after *Stewart*, the Supreme Court clarified “capable” ***to support the “No” Position***.
  - *Lozman v. City of Riviera Beach, Fla.* ruled a “floating home” was not a “vessel” under a federal maritime statute, even though “the home was ‘capable’ of transportation because it could float.” 568 U.S. 115, 120 (2013).
  - The Court stated “capable” of transportation means the structure has the “characteristics and activities [which] would consider it designed to a practical degree for carrying people or things over water.”
  - Thus, *Lozman* rejected the “Yes” position’s view that “capable” means only “possible,” or “having potential,” and instead **supports the “No” Position that “capable of” means *no material restrictions in practice.***

The “Yes” Position Improperly Construes Plain Meaning

The “Yes” Position asserts the “No” Position requires that the External Reviewers read *additional words* into the Definitions. (Yes Br., at 7-8).

- **<u>This is incorrect</u>**:
  - The “No” Position requires only consent, just like the Consent Required Loan.
  - The “Yes” Position requires *additional words*. For example, the “Yes” Position reads in added restrictions as follows:

    > “is capable of being ***assigned or novated to a commercial bank . . . with combined capital and surplus in excess of $300,000,000 . . . and*** with the consent of the Reference Entity or the guarantor, if any, of such loan (or the consent of the relevant borrower if the Reference Entity is guaranteeing such loan) or any agent.”

  - The drafters knew what they were drafting—and they *did not include this additional restriction*. Adding this additional restriction is contrary to the drafter’s intent, notwithstanding the “Yes” Position’s strained interpretation to the contrary.

Proper Context Further Shows that the "Yes" Position Improperly Construes the Plain Meaning

- The Definitions of Assignable Loan, Transferable, Fully Transferable Obligation and Conditionally Transferable Obligation *all* show further that the "Yes" Position ***improperly construes plain meaning***.
- Unlike the Consent Required Loan provision, the Assignable Loan Deliverable Obligation Characteristic broadly **specifies a range of persons** (commercial banks and financial institutions) "capable of" receiving assigned or novated loans.
  - The Assignable Loan's use of "commercial banks" and "financial institutions" is broader than the Eligible Assignee restrictions – this suggests that *the holder should have flexibility to deal with many potential transferees*.
  - The drafters intentionally included "commercial banks" and "financial institutions" – these entities are likely interested in acquiring a Loan.
- Even then, the drafters ***did not require*** a transfer to "commercial banks" and financial institutions" – valid reasons, such as lack of corporate capacity, could prevent particular entities from being assignees.
- The question is whether the relevant Loan is capable of being assigned to the specified persons *generally*, not to every single entity within the range of specified persons.
- The same points apply to the Transferable Deliverable Obligation Characteristic.

The “Yes” Position Is Wrong: Whether The Eligible Assignee Restrictions Are Objective and Reasonable is Irrelevant

The “Yes” Position argues that because the Consent Required Loan contains a subjective consent limitation, the drafters would not object to the “addition of objective standards” to the Consent Required Loan, “at least where such standards are reasonable.” (Yes Br., at 9).

- **<u>This is incorrect</u>**:
  - It is contrary to the plain meaning of the Consent Required Loan.
  - The Definitions of Assignable Loan, Transferable, Fully Transferable Obligation and Conditionally Transferable Obligation, demonstrate the drafters could have – *but did not* – include further “objective” restrictions in the Consent Required Loan, such as the persons to whom transfer can be made.
  - The “Yes” Position argues against “carte blanche…arbitrar[y] refus[al]” of consent (Yes Br., at 11), but under either the “Yes” or the “No” Position, there is discretion, and whether it is ultimately reasonable to withhold consent depends on the circumstances of the loan.
  - Simply put, the Consent Required Loan provision *does not set out circumstances for refusing consent*. Rather, the capital requirement is *separate*—it is an ***additional restriction*** that narrows the universe of Eligible Assignees.
  - Even if consent has to be “commercially reasonable,” the Consent Required Loan provides the parties with commercially reasonable flexibility that the Eligible Assignee definition improperly restricts.

The "Yes" Position Is Wrong: Whether The Eligible Assignee Restrictions Are Objective and Reasonable is Irrelevant

The "Yes" Position argues that the remaining question is whether the Eligible Assignee restrictions are reasonable in scope, and that $300,000,000 capitalization requirement "is a reasonable proxy for sufficient capital and sophistication."

- **<u>This is incorrect</u>**:
  - The "Yes" Position claims that 4,862 SEC-registered investment advisors have assets under management exceeding $600 million. (Yes Br., at 12). **But**, at least 8,405 SEC-registered investment advisors *do not* meet this $600 million threshold.
  - Under federal law, **$150 million under management is a proxy for sophistication**:
    - In 2010, Congress and the SEC limited exemption for an investment advisor to register under the Investment Advisors Act if it "solely advises private funds [and] has assets under management in the United States of less than $150 million." 15 U.S.C. § 80b-3.
  - "***Congress made the considered decision to alter the scope of the exemptions from registration under the Advisers Act in an effort to ensure that advisers to certain larger, more interconnected, private funds — such as hedge funds — would be registered with the Commission***." Kathleen L. Casey, SEC Commissioner, Speech by SEC Commissioner: Statement at SEC Open Meeting (Nov. 19, 2010).
  - Potential use of nominees / participation fails to address that: (a) these are not an assignment = irrelevant; (b) additional costs involved; (c) Seller unable to deliver under a second CDS – contracts generally do not permit participations; and (d) disposal of loan in secondary market via participation still requires settlement of second CDS in some other way.

The "Yes" Position Is Wrong: Whether The Eligible Assignee Restrictions Are Objective and Reasonable is Irrelevant

The "Yes" Position claims that all CDS contracts will settle without issue, and "the Definitions and structure of the CDS auction mitigate any small risk that inclusion of an Eligible Assignee Loan might disrupt the settlement of the CDS contract." (Yes Br., at 13).

- **<u>This is incorrect</u>**:
  - The interpretation of the Consent Required Loan provision cannot depend on whether Auction or Physical Settlement applies, but instead has to work in both scenarios.
  - The "Yes" Position states, "on the buy side in the auction," it is "highly unlikely that" a party that cannot satisfy the $300 million requirement "would be a seller of CDS protection."
    - **<u>As explained, this is incorrect, and not a proper restriction</u>:** there is *no basis* for the "Yes" Position to conclude that a *de facto* $300 million threshold on any party selling CDS is *acceptable*.
  - Buyers in certain transactions would remain exposed to Reference Entities.
  - Where Auction Settlement applies, there may be an adverse effect on the price at Auction as a result of material restrictions as to who the loan can be transferred.
  - The "Yes" Position concedes that some Physical Settlement will apply (saying only "nearly all" settle through auction).
  - Where Physical Settlement applies, an improper hedging mismatch will arise if there are any constraints on the transfer of the Loan that go beyond the need to obtain the requisite consents.

The “Yes” Position Is Wrong: Whether The Eligible Assignee Restrictions Are Objective and Reasonable is Irrelevant

The “Yes” Position argues “the reasonableness of the Eligible Assignee provisions is confirmed by their prevalence in the market.” For example, “at least nine other credit agreements [have] similar restrictions governing debt of reference entities” and “five have capital and surplus (or total asset) requirements equal to or greater than $300 million.” (Yes Br., at 15).

- **<u>This is incorrect</u>**:
  - **“Yes” Exhibit E** also identifies 10 other credit agreements with no – ***zero*** – capital requirements, or capital requirements of less than $300 million.
  - At least 4 such agreements – involving Hess, JC Penny, Supervalu, T-Mobile – state that an Eligible Assignee must be an “accredited investor.” Thus, this is the $100 million threshold that the SEC has deemed important. (No Br., at 18). This shows further that the $300 million requirement is a *material restriction*.
  - Several of the credit agreements in **Exhibit E** have capital requirements exceeding $1 billion, and our research found capital requirements of up to $10 billion: If the “Yes” Position is right, parties can set ***extremely high capitalization bars***, increasing the risk to Sellers even more.
  - A leading market participant provided advice to the DC, which is consistent with the “No” Position and reflects, factually, what the market views as reasonable.
  - **Exhibit E** and our research demonstrate that the **market distinguishes between 2 types of loans**: **(1) transferable only with consent; and (2) subject to additional restrictions.** ***This makes clear that the Consent Required Loan provision is intended to cover loans that are freely transferrable with consent***.

The “Yes” Position Is Wrong: Policy Does Not Favor the “Yes” Position

The “Yes” Position argues that the “No” Position will not further a policy objective, that excluding loans will frustrate market expectations and distort the auction process, and that the “Yes” Position accommodates changes in the loan market and presents “virtually no downside.” (Yes Br., at 16-17).

- **<u>This is incorrect</u>**:
  - The market *expects no further restrictions* in the Consent Required Loan Definition.
  - The “Yes” Position would devalue the Consent Required Loan provision.
  - The inflexible restrictions in Eligible Assignee ***restricts***, not accommodates, changes in the market.
  - The “Yes” Position fails to explain how a “squeeze” would occur – CDS participants will not be forced to acquire Deliverable Obligations in the market. The auction will proceed on the basis of demand for other Deliverable Obligations on the list.
  - The “Yes” Position may cause an improper basis risk to arise in the market .
  - Recent changes in the loan market are not relevant to the interpretation of existing CDS contracts.

The “Yes” Position Is Wrong: Policy Does Not Favor the “Yes” Position

- The Deliverable Obligation Characteristics are important – they set criteria for an Obligation to constitute a Deliverable Obligation.
- The absence of additional constraints is in line with market expectations and avoids transaction mismatches
- The “No” Position is in line with leading texts on English derivatives law, *Derivatives Law and Practice* (S. Firth, Sweet & Maxwell, London, loose-leaf), provides:

  “…if any additional conditions must be met, such as a restriction on the types of person to which the Loan may be transferred, the Deliverable Obligation Characteristic will not be satisfied, at least if the restriction extends to persons to which a participant in the secondary loan market might reasonably wish to sell the Loan.” ¶16.174 (**“No” Exhibit 2**).