Sears CDS ‘torpedo’ attempt

Credit event manipulation casts new shadow on instrument

After filing for bankruptcy earlier this year, Sears is now at the centre of a high-profile saga in relation to credit event manipulation affecting its associated CDS. Various tactics have now been employed by interested parties to prevent the firm’s liquidation, which could reduce any pay out on the CDS, raising further questions about the instrument’s viability.

Brian Guiney, of counsel at Patterson Belknap, comments that the Sears CDS saga began on 9 November when, in the days leading up to its bankruptcy, Sears publically sought permission to auction certain medium-term notes (MTNs) issued by Sears Roebuck Acceptance Corp (SRAC). On 14 November, Cyrus Capital objected to this, claiming it would be increasing the pool of defaulted securities for which sellers of credit protection, like Cyrus, would have to cover when the loss percentage is determined at auction which, they argue, isn’t in the best interest of the SRAC bankruptcy estate.

The motion by Sears to auction the MTNs was, however, approved, despite the “troubling implications of allowing the subject of credit protection to openly attempt to manipulate the CDS market in which it is not itself a direct participant,” says Guiney.

Guiney notes, however, that the approval order also states that the MTNs are not being sold free and clear of any liens or claims of SRAC and that nothing in the order will impair or prejudice any rights, claims or defences that SRAC or its estate may have in connection with the MTNs. He suggests that this therefore constitutes a “partial victory” for Cyrus, because it preserves any defence to payment of the MTNs that SRAC or its estate/creditors might wish to assert in future.

Assia Damianova, special counsel at Cadwalader, Wickersham & Taft, suggests that Cyrus Capital is under most scrutiny in terms of credit event manipulation: “In deploying such strategies,” she says, “Cyrus has been accused by other market participants of trying to torpedo the CDS auction, by making the Sears notes issued by the CDS reference entity undeliverable.”

Damianova adds that it appears to be an opportunistic approach from Cyrus, done with the hope of either stopping the notes of the reference entity from coming to market, or changing the terms to make them undeliverable in a CDS auction. The issue with such an approach, she adds, is that it may hinder the functioning of an otherwise useful instrument for both buyers and sellers of protection.

As a result, this is another instance that shows that buyers of CDS need to be very wary about the influence particular, significant investors in the reference entity can have, if such investors also have CDS positions. In this instance, adds Damianova, Cyrus is an investor and a reported seller of protection so it would have a vested interest in enticing Sears to make the notes in question unavailable for the CDS auction.

Additionally, she notes: "Cases like this question the viability of single-name CDS and investors will certainly look at this and ask what the value of paying for protection under a CDS is, when investors feel they won't receive a pay out at the end anyway."

However, while such tactics erode confidence in the product, there may be limited options available to prevent similar, future occurrences, although Damianova suggests that "regulation may be a way forward". She says, however, that the moves by firms to influence CDS outcomes aren't illegal, unless there is a basis to say that certain firms are manipulating the market and influencing the price of some listed securities, which "doesn't seem to be the case" with Sears.

Regardless, the impact on the sector isn't positive. She concludes: "if you end up with an unrealistic price of deliverables in this way, it does distort the wider CDS market. It creates a great deal of uncertainty around the outcome for the particular credit event and the resulting auction and more broadly for the efficacy of single-name CDS."

In the latest update, the credit derivatives determinations committee (DC) has resolved to select Andy Brindle and Charles Whitehead as external reviewers. In addition, the DC Secretary randomly selected Jeffrey Golden as an external reviewer, and Don Thompson and Athanassios Diplas as first and second alternates respectively, in accordance with the DC rules.

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