Mr. Joshua B. Sterling
Director
Division of Swap Dealer and Intermediary Oversight
U.S. Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

June 16, 2020

RE: REQUEST FOR NO-ACTION LETTER REGARDING THE APPLICATION OF CERTAIN SWAP REGULATORY REQUIREMENTS TO CERTAIN SWAPS IN THE CONTEXT OF CERTAIN DERIVATIVE CLEARING ORGANIZATIONS' DISCOUNTING TRANSITION

Dear Mr. Sterling,

The Alternative Reference Rates Committee (**"ARRC"**) and its member firms are writing to request no-action relief from the Division of Swap Dealer and Intermediary Oversight (**"DSIO"**) of the U.S. Commodity Futures Trading Commission (**"CFTC"** or **"Commission"**) under the Commodity Exchange Act (**"CEA"**) and CFTC regulations implementing the CEA regarding the treatment of certain swaps that are amended as part of the effort to transition to reference risk-free rates (**"RFRs"**) in connection with the upcoming discontinuation of the London Interbank Offered Rate (**"LIBOR"**) and other inter-bank offered rates ("**IBORs**"). In particular, to supplement the IBOR-transition-related relief previously issued by the DSIO, the ARRC is requesting no-action relief associated with upcoming discount rate changes by certain derivatives clearing organizations ("**DCOs**").

I. Introduction

The ARRC appreciates the DSIO's issuance of CFTC Letter No. 19-26, which provided relief from some swap regulatory requirements under the CEA and CFTC regulations, including the uncleared swap margin requirements, for "Qualifying Amendments"[1] (such requirements, the "**IBOR No-Action Letter Covered Requirements**") to facilitate an orderly transition from IBORs to alternative benchmarks (the "**IBOR No-Action Letter**"). This relief addressed many of the regulatory issues the ARRC believes would otherwise materially hinder a smooth and orderly transition.[2] We now request specific modifications to the relief provided in the IBOR No-Action Letter for Qualifying Amendments to address

[1] The IBOR No-Action Letter defines Qualifying Amendments as "the amendment of an uncleared swap that references an IRR [Impaired Reference Rate, defined elsewhere in the IBOR No-Action Letter] solely to: (i) include new fallbacks to alternative reference rates triggered only by permanent discontinuation of an IRR or determination that an IRR is non-representative by the benchmark administrator or the relevant authority in a jurisdiction; or (ii) accommodate the replacement of an IRR."

[2] The ARRC's Regulatory Issues Working Group (**ARRC WG**) on April 9, 2020 shared with Commission staff a document titled *Areas of Significant Concern Regarding CFTC IBOR Transition Relief*, which described the ARRC WG's concerns with Commission staff IBOR-transition no-action relief. Although this present request raises a targeted subset of the concerns in that document particularly in need of expedited relief, the ARRC WG continues to believe that Commission staff should address all of the concerns raised in the April 9 document.

certain additional changes associated with the IBOR transition as a result of the DCO discounting changes.

After the ARRC's initial requests for CFTC relief or clarification, the ARRC and various market participants have taken additional steps to further progress the transition. Consistent with the ARRC's paced transition plan, certain DCOs, in particular the Chicago Mercantile Exchange ("**CME**"), the London Clearinghouse ("**LCH**") and Eurex Clearing ("**Eurex**") have announced that they intend to change the discount rate that they use for purposes of valuing cleared swaps and the rate (commonly referred to as the Price Alignment Interest rate or the Price Alignment Amount rate, depending on the context) applied to collateral or settlement amounts relating to certain cleared swaps. Specifically, CME and LCH intend to transition from using the daily effective federal funds rate ("**EFFR**") to the Secured Overnight Financing Rate ("**SOFR"**) as of October 2020 with respect to USD discounted swaps. In addition, CME, LCH and Eurex intend to transition from using the Euro OverNight Index Average ("**EONIA**") to the Euro Short Term Rate ("**€STR**") as of July 2020 with respect to EUR discounted swaps.[3]

These DCO changes will apply to both existing and new cleared swaps. With respect to the switch from EFFR to SOFR, both CME and LCH will provide a mechanism to compensate clearing members and customers for the change in the *value* of the existing cleared swaps as a result of the switch and will create and register various EFFR and SOFR basis swaps to hedge clearing members' and customers' change in *discounting risk* profile as a result of such switch. With respect to the switch from EONIA to €STR, CME, LCH and Eurex will provide a mechanism to compensate clearing members and customers for the change in the *value* of the cleared swaps as a result of the switch.

The changes could also affect the value of many uncleared USD and EUR denominated swaptions that exercise into cleared swaps or that cash settle by reference to the discounting rates employed by CME, LCH or Eurex after the date on which the change in discounting rate occurs. To facilitate the DCOs' discounting rate changes and to account for their effect on swaptions, the ARRC issued a public consultation on swaptions impacted by this discounting transition.[4] On May 14, 2020, the ARRC

[3] *See* CME Group, SOFR & €STR Discounting & Price Alignment Transition Process for Cleared Swaps, Q2 2020, *available at* https://www.cmegroup.com/trading/interest-rates/files/discounting-transition-proposal-mar-2020.pdf; LCH, Letter to All SwapClear Users re: Proposed Next Steps for Transition to USD SOFR Discounting in SwapClear, July 26, 2019, *available at* https://www.cftc.gov/media/3221/MRAC_LCH_SOFRDiscountingLetter121119/download (transition from EFFR to SOFR as of October 2020); LCH, Ltd Member Updates, Transition to €STR Discounting in SwapClear, September 27, 2019, *available at* https://www.lch.com/membership/ltd-membership/ltd-member-updates/transition-eustr-discounting-swapclear (transition from EONIA to €STR, originally as of June 2020); LCH, Ltd Member Updates, Transition to €STR Discounting: Updated Timing, April 17, 2020, *available at* https://www.lch.com/membership/ltd-membership/ltd-member-updates/transition-to-%E2%82%ACSTR-Discounting-Updated-Timing (moving date of transition from EONIA to €STR to July 2020); Eurex Clearing, Circular 096/19, EurexOTC Clear Service: Discounting Switch from EONIA to €STR for Cleared OTC EUR Derivatives, October 23, 2019, *available at* https://www.eurexclearing.com/clearing-en/resources/circulars/clearing-circular-1653578 (transition from EONIA to €STR, originally as of June 2020); Eurex Clearing, Circular 032/20, EurexOTC Clear: Postponement of EurexOTC Clear Release 10.1, April 17, 2020, *available at* https://www.eurexclearing.com/clearing-en/resources/circulars/clearing-circular-1942440 (moving date of transition from EONIA to €STR to July 2020).

[4] *See* Alternative Reference Rates Committee, ARRC Releases Consultation on Swaptions Impacted by Central Counterparty Clearing Houses' Discounting Transition to SOFR, February 7, 2020, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Swaptions_Consultation.pdf.

announced the results of that consultation, recommending, among other things, that market participants (i) amend USD swaptions expiring after October 16, 2020 so that they include ISDA Supplement 64 to the 2006 ISDA Definitions[5] and to specify SOFR as the Agreed Discount Rate, and (ii) simultaneously voluntarily exchange compensation for the difference in the value of these swaptions between EFFR discounting and SOFR discounting.[6] The ARRC further recommended that market participants contact their swaptions counterparties **"no later than June 30, 2020"** (emphasis added) to determine whether they will follow these recommendations.[7] The ARRC further noted that "[p]rompt determination is recommended to: (a) avoid an extended period of uncertainty; (b) minimize any valuation difference because the market-implied basis between EFFR and SOFR is currently fairly narrow (in absolute value); and (c) promote responsible risk management and market liquidity and resiliency."[8]

While the ARRC consultation and its recommendations apply only to USD-denominated swaptions, the Working Group on Euro Risk Free Rates undertook a similar consultation[9] for EUR-denominated swaptions. The results of that consultation noted that market participants also broadly supported the exchange of voluntary compensation in that context.[10]

II. Application of IBOR No-Action Letter Covered Requirements for Uncleared Swaps

As discussed in the IBOR No-Action Letter, amendments to legacy uncleared swaps may, absent relief, trigger various requirements under the CEA and CFTC regulations. The IBOR No-Action Letter provides relief from the IBOR No-Action Letter Covered Requirements, including, for example, uncleared swap margin requirements,[11] where a swap is amended for purposes of the IBOR transition by means of a Qualifying Amendment. This present letter requests that relief from the IBOR No-Action Letter Covered Requirements be expanded beyond the present definition of Qualifying Amendments to include certain expected changes by counterparties to swaptions in response to the DCOs' discount rate transition. In particular, there is uncertainty whether existing swaptions not currently subject to IBOR No-Action Letter Covered Requirements may become subject to those requirements by virtue of an amendment to voluntarily exchange compensation or to change the discount rate to be applied for settlement of the swaption.

a. Discussion

Discounting Amendments

It is possible to take the view that an agreement between swaption counterparties to voluntarily exchange compensation or an amendment of a swaption's terms to specify the discount rate to be applied for

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[5] The ARRC's announcement, see n.6, explained that Supplement 64 was released by ISDA on March 30, 2020 and allows parties to specify an Agreed Discount Rate in swaptions.
[6] *See* Alternative Reference Rates Committee, ARRC Recommendations for Swaptions Impacted by the CCP Discounting Transition to SOFR, May 14, 2020, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-swaptions-recommendations.pdf
[7] *Id.*
[8] *Id.*
[9] *See* Working Group on Euro Risk-Free Rates, Public Consultation by the Working Group on Euro Risk-Free Rates on Swaptions Impacted by the CCP Discounting Transition from EONIA to the €STR, March 13, 2020, *available at* https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/ecb.public_consultation_20200313.en.pdf.
[10] *See* Working Group on Euro Risk-Free Rates, Public consultation on swaptions impacted by the CCP discounting transition from EONIA to the €STR, May 2020, *available at* https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/ecb.202005.swaptionsfeedbacksummary.en.pdf.
[11] CEA § 4s(e); 17 C.F.R. §§ 23.150–.161.

settlement of the swaption, in the context of transitioning from EFFR or EONIA to SOFR or €STR, as applicable, may trigger the application of the IBOR No-Action Letter Covered Requirements for swaps not currently subject to those requirements. Although this is not the only possible interpretation, there is a lack of clarity in the current IBOR No-Action Letter because such an exchange or discount rate modification would not clearly meet the definition of "Qualifying Amendment" under the DSIO's existing IBOR No-Action Letter, which is defined to include an amendment made solely to accommodate the replacement of an Impaired Reference Rate.[12]

In this case, the exchange of compensation or discount rate modification would occur because of an agreement regarding the discount rate at the applicable DCO, and not because of a change in the reference rate of the swap itself. Moreover, although EONIA meets the standard of an "impaired reference rate" as defined in the IBOR No-Action Letter since it is reasonably expected to be discontinued in January 2022, EFFR does not.

We are concerned that a lack of regulatory clarity with respect to discounting changes and the exchange of compensation prompted by the DCO changes discussed above will significantly impede the "big bang" moment that the market had hoped would accelerate voluntary transition initiatives.[13] As the ARRC has articulated, the discounting change from EFFR to SOFR represents an important milestone for the transition to SOFR because it is fundamental to building SOFR liquidity and furthering its use in financial markets.

Amendments to Credit Support Annexes

In addition, the ARRC notes that market participants may also choose to align the interest rates paid on posted collateral for uncleared swaps with the discount rate change implemented by the DCOs for cleared swaps described above. For example, a swap dealer may offset the risk of an uncleared swap with a third party by entering into a cleared swap. In such cases, the swap dealer will customarily seek to align the interest rate used in an existing credit support annex ("**CSA**"), including from non-impaired rates, with the discount rate used by the DCO to avoid basis risk. The ARRC's Recommended Best Practices also encourage dealers to amend their interdealer CSAs to use SOFR for USD collateral by December 31, 2020,[14] and, because EONIA will be discontinued in January 2022, market participants will need to amend their CSAs referencing EONIA. Amending credit support documents will not only eliminate the potential basis risk that would otherwise exist between the cleared and uncleared swap markets, but will also provide greater liquidity for market participants across both markets.

Amending a CSA in the manner described above may not trigger application of the IBOR No-Action Letter Covered Requirements. For example, such amendments may not constitute the "entry into" a "swap" for purposes of such requirements. With respect to the CFTC's uncleared swap margin

[12] The IBOR No-Action Letter defines "Impaired Reference Rates" as (i) IBORs, (ii) any other interest rate that the parties to a swap reasonably expect to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment; or (iii) any other reference rate that succeeds any of the foregoing.

[13] Although this letter is limited to the immediate time-sensitive request associated with the discounting transition, the ARRC believes that there are other scenarios that may require similar relief regarding the fact that the rate being transitioned out of is not "impaired" under the DSIO's definition. It is the ARRC's view that so long as the rate being transitioned into represents an RFR, and the purpose of the transition is to facilitate the IBOR transition and enhance market stability, similar relief from the DSIO and applicable other CFTC divisions should apply.

[14] *See* Alternative Reference Rates Committee, ARRC Recommended Best Practices for Completing the Transition from LIBOR, May 27, 2020, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf.

requirements, amendments to the interest rates in CSAs may be immaterial amendments that would already be eligible for relief under CFTC Letter No. 19-13.[15] However, market participants would greatly benefit from clarity regarding the status of such CSA amendments in order to ensure a smooth and orderly transition. Therefore, we request that the Commission confirm that the CSA amendments described above would not trigger application of the IBOR No-Action Letter Covered Requirements.

b. Request for Relief

The ARRC therefore requests that the DSIO grant no-action relief providing that the exchange of voluntary compensation for a swaption, or the amendment of a swaption's terms to reflect an agreement regarding the discount rate that will be used by a DCO in advance of the DCO changes described above would be treated as a Qualifying Amendment under the IBOR No-Action Letter and that therefore such actions would not result in the swap being newly subject to IBOR No-Action Letter Covered Requirements, including uncleared swap margin requirements.

The ARRC would appreciate the DSIO's feedback as soon as possible on this matter to enable market participants to meet the ARRC's June 30, 2020 deadline regarding contacting counterparties to amend swaptions to be brought in-scope for ISDA Supplement 64 and to specify SOFR as the Agreed Discount Rate and to discuss the exchange of voluntary compensation.

III. Conclusion

The ARRC appreciates the DSIO's continued engagement on these regulatory matters associated with the IBOR transition and looks forward to a continued dialogue with regulatory authorities as additional regulatory clarity and guidance is needed to facilitate this transition.

[15] *See* CFTC DSIO, CFTC Letter No. 19-13, No-Action Position: Application of Uncleared Swap Margin Rules to Immaterial Amendments, Swaption Exercises, Partial Terminations, Partial Novations, or Multilateral Compression of Legacy Swaps (June 6, 2019), *available at* https://www.cftc.gov/csl/19-13/download.

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Thank you for your consideration of our request. Please feel free to contact Priya Bindra (212-537-2119 or priya.bindra@morganstanley.com), Simon Winn (917-472-4305 or simon.winn@us.bnpparibas.com), co-chairs of the Alternative Reference Rates Committee's Regulatory Working Group or Jai R. Massari (202-962-7062 or jai.massari@davispolk.com) should you have any questions or concerns.

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