SULLIVAN & CROMWELL LLP

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December 17, 2021

CFTC Solicits Input on Swap-Clearing Requirement in Light of LIBOR Transition

The Commodity Futures Trading Commission Issued a Request for Information and Comment Regarding Potential Actions with Respect to its Swap-Clearing Requirement to Address the Upcoming Cessation of the London Interbank Offered Rate.

SUMMARY

On November 17, 2021, the Commodity Futures Trading Commission (the "Commission" or the "CFTC") issued a request for information and comment regarding whether the Commission should amend its swap-clearing requirement rules, or take other actions, to address the cessation of certain interbank offered rates ("IBORs") (e.g., the London Interbank Offered Rate ("LIBOR")) used as benchmark reference rates in various derivatives contracts, including many subject to the clearing requirement, and the market adoption of alternative reference rates – namely, overnight, risk-free reference rates ("RFRs"), such as the secured overnight financing rate ("SOFR"). The CFTC is requesting information and comments on these issues but has not yet proposed actual changes or actions.

A. BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Commodity Exchange Act (the "CEA") to require, among other things, that a swap be cleared though a derivatives clearing organization (a "DCO") if the Commission has determined that the swap, or class of swaps, is required to be cleared, unless an exception to the clearing requirement applies.[1] To date, the Commission has issued two clearing requirement determinations: the first in 2012 and the second in 2016.[2] The classes of swaps that are required to be cleared are outlined in Commission Regulation 50.4 (the "Clearing Requirement") and include certain indexed credit default swap and interest rate swaps in four currencies and in four classes, including fixed-to-floating swaps, basis swaps, forward rate agreements ("FRAs") and overnight index swaps ("OIS").[3] The Commission's Clearing Requirement currently covers a number of swaps that reference LIBOR[4] and other IBORs, including swaps in multiple currencies in each of the fixed-to-floating swap, basis swap, and FRA classes.[5]

On March 5, 2021, the U.K. Financial Conduct Authority (the "FCA") announced that publication of LIBOR would not be provided by any administrator or be compelled after the final publication on Friday, December 31, 2021, for the following: (i) EUR LIBOR in all tenors; (ii) CHF LIBOR in all tenors; (iii) JPY LIBOR in the spot next, 1-week, 2-month, and 12-month tenors; (iv) GBP LIBOR in the overnight, 1-week, 2-month, and 12-month tenors; and (v) USD LIBOR in the 1-week and 2-month tenors.[6] Additionally, the FCA determined that USD LIBOR in the overnight and 12-month tenors would cease after June 30, 2023, and that USD LIBOR in the 1-month, 3-month, and 6-month tenors would not be representative after that date.[7]

To address the upcoming cessation of LIBOR, regulators and working groups have sought to identify, develop, and implement alternative reference rates. For example, in 2014, the Federal Reserve Board and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (the "ARRC") as a body for private-market participants, alongside banking and financial sector regulators, to identify alternatives to USD LIBOR and help ensure an orderly transition to alternative reference rates.[8] On June 22, 2017, after studying several alternative reference rates and considering the input of market participants, the ARRC selected the Secured Overnight Financing Rate ("SOFR") as its preferred alternative to USD LIBOR. Efforts to develop and implement alternative reference rates are also being undertaken in other jurisdictions.[9] The discontinuation (or lack of representativeness) of LIBOR, and regulatory efforts to encourage the use of SOFR and other risk-free rates, could affect swap contracts that incorporate LIBOR (including those subject to the Clearing Requirement) and the broader swaps markets, including with respect to market liquidity and pricing.[10] This concern, among others, has prompted the CFTC to solicit comments regarding the Clearing Requirement, as described in more detail below.[11]

B. REQUEST FOR COMMENT

As the international regulatory community and financial markets transition from IBORs to alternative reference rates, the Commission is requesting information and comment with respect to the swaps currently subject to the Clearing Requirement, and whether the Commission should update any of its prior determinations due to the ongoing and anticipated market-wide shift in reference rates from LIBOR and other IBORs to RFRs.[12]

Comments may be submitted electronically through the **CFTC Comments Portal** on or before January 24, 2022.

1. General Request for Comment

The Commission requests comment on all aspects of the swap-clearing requirement and any related regulations that may be affected by the transition away from LIBOR and the other IBORs to alternative reference rates.[13] The Commission seeks comments on these matters generally, and commenters are encouraged to address any relevant matters that are not specifically identified in the requests for comment below.[14]

In responding to this general request for comment and the specific requests for comment outlined below, the Commission encourages commenters to provide empirical support for their arguments and analyses.[15] Furthermore, comments that identify and provide specific information or data that would be relevant to the Commission's considerations discussed in this request for comment would be of the greatest assistance to the Commission.[16] Additionally, the Commission recognizes that the information related to the IBOR transition is changing regularly, and the Commission invites commenters to assume certain facts or information that may have changed or been released after this document was published for comment, and would appreciate comments identifying any relevant information that the Commission may have missed in its review.[17] The Commission welcomes comments based on new or updated information when responding to the questions below.[18]

2. Specific Requests for Comment

I. Current Swap-Clearing Requirement-Related Questions

The Commission has identified a number of specific questions on which it seeks comment, although it has invited comment generally on any other issues that commenters wish to address. The following are some of the specific issues raised:

1. Whether market participants are concerned about access to clearing for certain swaps that are subject to the Clearing Requirement and, if so, whether there are there any Commission actions or regulatory amendments that could facilitate the IBOR transition.

2. Whether market participants have any recommendations for modifications of the Clearing Requirement and, if so, any advantages or disadvantages of possible approaches.

3. Whether the Commission should modify the termination date range, or any other specifications, with respect to SONIA OIS, AONIA OIS, CORRA OIS or any other OIS that are subject to the Clearing Requirement and for which the index has been nominated as an alternative reference rate. If such an amendment is recommended, the Commission requests feedback on a potential timeline for considering and adopting a modification and the reasons for adopting such timeline.

4. Whether the Commission should revise the clearing requirement related to the SGD SOR-VWAP rate as part of the initial LIBOR transition, or whether market participants should be given additional time to consider changes to the SGD SOR-VWAP Clearing Requirement because it is based on USD LIBOR (and may continue until 2023).[19]

II. Swap-Clearing Requirements for Alternative Reference Rates

The Commission also seeks comments regarding the applicability of swap-clearing requirements to contracts that incorporate alternative reference rates, including, but not limited to, the following:

5. Whether market participants are concerned about access to clearing for certain swaps that reference alternative reference rates and are not currently subject to the Clearing Requirement. If so, the Commission requests an explanation of the current or anticipated barriers to clearing swaps in alternative reference rates.

6. Whether there are specific data the Commission should consider in determining whether significant notional amounts and liquidity exists in swaps referencing SOFR or other alternative reference rates that are not currently subject to the Clearing Requirement.

7. Whether there are specific thresholds that the Commission should apply with respect to notional amount and liquidity in determining whether swaps referencing SOFR or other alternative reference rates that are not currently subject to the Clearing Requirement should become subject to a clearing requirement.

8. Whether market participants have observed sufficient outstanding notional exposures and trading liquidity in swaps referencing SOFR during both stressed and non-stressed market conditions to support a clearing requirement.

9. An explanation, including supporting data, of why it would or would not mitigate systemic risk to require swaps that reference SOFR to be cleared.

10. Whether market participants have any recommendations for how and when the Commission should evaluate requiring clearing for interest rate swaps denominated in USD that reference alternative reference rates other than SOFR, such as credit-sensitive benchmark rates (e.g., Ameribor and BSBY). Provided that one or more DCOs have made such swaps available for clearing, the Commission also seeks comment on whether there are additional factors or considerations beyond those specified in Section 2(h)(2)(D)(ii) of the CEA that the Commission should consider in determining whether to adopt a clearing requirement for such swaps.

11. Whether market participants have recommendations with respect to new information, if any, the Commission should consider as it prepares to review whether interest rate swaps linked to the alternative reference rates should be subject to a clearing requirement. Additionally, the Commission seeks comments on whether there are specific regulatory requirements that the Commission should consider when reviewing overall market conditions, such as uncleared margin requirements implemented by prudential regulators and/or the uncleared margin requirements for swap dealers and major swap participants under part 23 of the Commission's regulations.[20]

III. New Swap Product Documentation

12. With respect to all new swap products, including those referencing alternative reference rates, whether there is additional documentation that the Commission should require DCOs to submit with swap submissions beyond the documentation that Commission Regulation 39.5 currently requires.[21]

IV. Swap-Clearing Requirement Specifications

13. The Commission requests comment on (i) whether it should designate any additional classes of swaps or specifications for purposes of classifying swaps under Commission Regulation 50.4 and (ii) suggestions on how to reorganize or structure the classes of swaps subject to the clearing requirement under Commission Regulation 50.4 (including whether the Commission should include a new class covering variable notional swaps as a table under Commission Regulation 50.4(a)).[22]

V. Cost-Benefit Considerations

14. The Commission requests comment, including supporting data, from DCOs and market participants on the nature and extent of any operational, compliance, or other costs that may be incurred as a result of potential changes to the Clearing Requirement in response to the market-wide shift to alternative reference rates.[23]

C. REQUEST FOR INFORMATION

The Commission has also requested that market participants provide it with certain information, including the following:

1. Whether any clearing member firms of DCOs have experienced challenges with respect to the transition from any IBOR to an alternative reference rate, and any related DCO conversion event, including whether and how such challenges were resolved, and whether clearing member firms believe there are any steps the Commission can take to help resolve ongoing challenges.

2. Submission of registered swap dealers' and other market participants' data related to market participants' outstanding net LIBOR risk as of November 30, 2021.[24]

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ENDNOTES

[1] See 86 Fed. Reg. 66476 (Nov. 23, 2021) ("Request for Comment"), available at: https://www.cftc.gov/sites/default/files/2021/11/2021-25450a.pdf.

[2] *Id*. *See also* Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule, 77 FR 74284 (Dec. 13, 2012) and Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps; Final Rule, 81 FR 71202 (Oct. 14, 2016).

[3] Request for Comment, *supra* note 1, at 66477.

[4] LIBOR is an interest rate benchmark that is intended to measure the average rate at which a bank can obtain unsecured funding in the London interbank market for a given tenor and currency. LIBOR is among the world's most frequently referenced interest rate benchmarks and serves as a reference rate for a wide variety of derivatives and cash market products.

[5] Request for Comment, *supra* note 1, at 66477.

[6] *Id*.

[7] *Id*. The future of USD LIBOR in the 1-month, 3-month, and 6-month tenors is uncertain because the FCA may decide to continue to publish those tenors based on a new methodology (i.e., on a synthetic basis). Following a public consultation on September 29, 2021, the FCA confirmed that it would require LIBOR's administrator to continue publishing GBP and JPY LIBOR in the 1-month, 3-month, and 6-month tenors, using a synthetic methodology based on term RFRs, through 2022.

[8] *Id* at 66479.

[9] *Id*. The Financial Stability Board's November 2020 report, Reforming Major Interest Rate Benchmarks, highlights plans to develop alternatives for numerous other IBORs. The transition to alternative reference rates in substitution for LIBOR, in particular, has been a priority for regulators and market participants following an announcement by Andrew Bailey, then-Chief Executive of the FCA, on July 27, 2017, that the FCA would not use its authority to compel or persuade LIBOR panel banks to contribute to the benchmark after 2021.

[10] *Id*. In determining whether a contract should become subject to the Clearing Requirement, the CFTC is required to consider the following factors: (i) the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data; (ii) the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is traded; (iii) the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCOs available to clear the contract; (iv) the effect on competition, including appropriate fees and charges applied to clearing; and (v) the existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

[11] *Id* at 66477.

[12] *Id* at 66477.

[13] *Id*.

[14] *Id*. A full list of the enumerated requests can be found at: https://www.cftc.gov/sites/default/files/2021/11/2021-25450a.pdf.

[15] *Id*.

[16] *Id*.

[17] *Id*.

[18] *Id*.

[19] *Id*.

ENDNOTES (CONTINUED)

[20] *Id* at 66488.

[21] *Id*.

[22] *Id*.

[23] *Id*.

[24] *Id* at 66487.

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