August 16, 2021

CFTC Update on the LIBOR Transition

Recent CFTC Statements and Recommendations Emphasize the Importance of the Transition Away from LIBOR

SUMMARY

The Commodity Futures Trading Commission's (the "CFTC" or the "Commission") Market Participants Division and Division of Market Oversight (the "Divisions") recently issued a joint statement to advise market participants and swap execution facilities ("SEFs") of the importance of ensuring a smooth and timely transition away from the London Interbank Offered Rate ("LIBOR").[1] Given that the timelines for the end of all LIBOR panels are now clear, the Divisions' staff believe that market participants must take steps to stop issuance of new derivatives linked to LIBOR and to transition away from LIBOR in legacy contracts as soon as practicable.[2] Further, the CFTC's Market Risk Advisory Committee ("MRAC") also recently unanimously adopted a recommendation that the CFTC adopt the SOFR First Transition Initiative ("SOFR First") as a best practice.[3]

A. BACKGROUND

On March 5, 2021, the United Kingdom Financial Conduct Authority ("FCA") formally confirmed that the majority of LIBOR panels will cease at the end of 2021, although a number of key USD settings will continue until the end of June 2023 to support the wind-down of legacy contracts.[4] On the same day, the International Swaps and Derivatives Association ("ISDA") stated that the FCA's announcement constituted an index cessation event, fixing the fallback spread adjustment published by Bloomberg for all Euro, Sterling, Swiss Franc, USD, and Yen LIBOR settings.[5] A number of market regulators around the world took subsequent action in response to these announcements. For example, the Financial Stability Board published a set of documents to help support the transition away from LIBOR by the end of 2021.[6] In addition, each of the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency recently issued answers to frequently asked questions regarding the impact of LIBOR transitions on regulatory capital instruments, which clarify that replacing or amending the terms of a capital instrument to transition from LIBOR to another reference rate is, subject to certain conditions, neither considered to be an issuance of a new instrument under the capital rules nor to be the creation of an incentive to redeem the instrument under the capital rules.[7] The banking regulators had earlier provided guidance that banking organizations should cease entering into new contracts referencing LIBOR as soon as practicable and, in any event, by December 31, 2021.[8] Similarly, the Securities and Exchange Commission had earlier encouraged market participants to identify existing contracts that extend past 2021 to determine their exposure to LIBOR and consider any necessary modifications, and, more recently, its Division of Examinations announced that assessing registrants' preparedness for the expected discontinuation of LIBOR will be one of its examination priorities in 2021.[9] These statements and initiatives make clear the global regulatory focus on the transition away from LIBOR.

B. THE DIVISIONS' STATEMENT

The Divisions note that they made their recent statement on LIBOR in light of the fact that the timelines for the end of LIBOR panels are now clear. Furthermore, given that the functioning of systemically important benchmarks is crucial to CFTC-regulated markets, the Divisions consider the cessation of and the transition away from LIBOR to be one of their most significant regulatory priorities.[10]

In the statement, the Divisions' staff expressed the view that continued reliance on LIBOR benchmarks poses risks to the stability and integrity of the derivatives markets, as well as to consumer protection.[11] Further, they noted that market participants and SEFs may also face financial, conduct, litigation, operational, and reputational risks if they are inadequately prepared for the transition, both with respect to ceasing the issuance of new derivatives linked to LIBOR and to shifting away from the use of LIBOR in legacy contracts.[12]

With these consequences in mind, the Divisions' staff stated that the use of LIBOR rates in new contracts should, with very limited exceptions, be stopped as soon as practicable and, at the latest, by December 2021.[13] Further, the staff indicated that market participants should accelerate their conversion of legacy LIBOR contracts and SEFs should likewise continue to focus on efforts to build liquidity in alternative reference rates in their markets.[14]

C. THE MRAC'S RECOMMENDATION

In addition to the Divisions' recent statement, the MRAC also recently unanimously adopted its recommendation that the Commission adopt SOFR First – which represents a prioritization of trading in the Secured Overnight Financing Rate ("SOFR") rather than USD LIBOR for particular market segments and products – as a best practice.[15] This embrace of SOFR First is modeled after the United Kingdom's Sterling Overnight Index Average ("SONIA") First model and is intended, in part, to help market participants decrease their reliance on USD LIBOR.[16] The first three phases of SOFR First only apply to the interdealer market; but the fourth, and final, phase applies more broadly.[17] The first phase applies to linear swaps and is recommended for July 26, 2021, with the additional phases applicable to other products later this year.[18] In addition, MRAC recommends that interdealer broker USD LIBOR linear swap screens may be available for informational purposes, but not trading activity, until October 22, 2021; after that, they should be turned off altogether.[19]

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ENDNOTES

1 *See* Statement from CFTC Staff on Transition Away from LIBOR (July 14, 2021), https://www.cftc.gov/PressRoom/SpeechesTestimony/mpddmosofrstatement071421 ("Divisions' Statement").

2 *See id*.

3 *See* CFTC Market Risk Advisory Committee Adopts SOFR First Recommendation at Public Meeting (July 13, 2021), https://www.cftc.gov/PressRoom/PressReleases/8409-21 ("MRAC Recommendation").

4 *See* FCA Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks (March 5, 2021), https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf.

5 *See* ISDA Statement on UK FCA LIBOR Announcement (March 5, 2021), https://www.isda.org/2021/03/05/isda-statement-on-uk-fca-libor-announcement/. In June 2021, ISDA launched a new consultation, in light of the FCA's March 5 announcement on LIBOR's future cessation, on how to implement fallbacks for certain swap rates published by the ICE Benchmark Administration. ISDA has recently announced the results of this consultation, which indicate that a significant majority of respondents agree with the fallback provisions set out in the draft amendments attached to the consultation. *See* ISDA Launches Consultation on Fallbacks for GBP LIBOR ICE Swap Rate and USD LIBOR ICE Swap Rate (June 11, 2021), https://www.isda.org/a/6zDgE/ISDA-Launches-ICE-Swap-Rate-Fallbacks-Consultation.pdf; ISDA Announces Results of Consultation on Fallbacks for GBP LIBOR ICE Swap Rate and USD LIBOR ICE Swap Rate (July 23, 2021), https://www.isda.org/2021/07/23/isda-announces-results-of-consultation-on-fallbacks-for-gbp-libor-ice-swap-rate-and-usd-libor-ice-swap-rate/.

6 *See* FSB issues statements to support a smooth transition away from LIBOR by end 2021 (June 2, 2021), https://www.fsb.org/2021/06/fsb-issues-statements-to-support-a-smooth-transition-away-from-libor-by-end-2021/.

7 *See* Answers to Frequently Asked Questions on the Transition Away from LIBOR (July 29, 2021), https://www.federalreserve.gov/supervisionreg/srletters/sr2112a1.pdf; Regulatory Capital Rule FAQ on LIBOR Transition (July 29, 2021), https://www.fdic.gov/news/financial-institution-letters/2021/fil21054a.pdf; LIBOR Transition: Regulatory Capital Rule Frequently Asked Questions (July 29, 2021), https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-32.html.

8 *See* Statement on LIBOR Transition (November 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf.

9 *See* Staff Statement on LIBOR Transition (July 12, 2019), https://www.sec.gov/news/public-statement/libor-transition; SEC Division of Examination Announces 2021 Examination Priorities (March 3, 2021), https://www.sec.gov/news/press-release/2021-39.

10 *See* Divisions' Statement.

11 *See id*.

12 *See id*.

13 *See id*.

14 *See id*.

15 *See* MRAC Recommendation.

16 *See* CFTC's Interest Rate Benchmark Reform Subcommittee Recommends July 26 for Transitioning Interdealer Swap Market Trading Conventions from LIBOR to SOFR (June 8, 2021), https://www.cftc.gov/PressRoom/PressReleases/8394-21.

17 *See* Divisions' Statement.

18 *See* MRAC Recommendation. In light of these changes to intradealer conventions effective July 26, the Alternative Reference Rates Committee ("AARC"), a group of private-market participants convened by the Federal Reserve Bank and the Federal Reserve Bank of New York in cooperation with a number of other governmental agencies, announced that it is formally recommending the CME Group as the administrator for a forward-looking SOFR term rate. *See* AAMC Releases Update on its RFP Process for Selecting a Forward-Looking SOFR Term Rate Administrator (May 21, 2021), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/20210521-ARRC-Press-Release-Term-Rate-RFP.pdf.

19 *See id*. Data from Clarus Financial Technology indicates that interest rate swaps referencing SOFR grew from 3% to 20% of the overall market over the past two months. Clarus attributed this shift in large part to the MRAC's SOFR First recommendation. See Radi Khasawneh, SOFR swaps market share jumps to 20% in July, FOW (August 2, 2021), https://www.globalinvestorgroup.com/articles/3697102/sofr-swaps-market-share-jumps-to-20-in-july.

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