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CFTC Issues Request for Information on Swap Clearing Requirements and LIBOR Transition

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TO: Derivatives Markets Advisory Committee
LIBOR Transition Working Group RE: CFTC Issues Request for Information on Swap Clearing Requirements and LIBOR Transition

On November 17, the Commodity Futures Trading Commission issued a request for information and comment (RFI) on amending its swap clearing requirements in light of the upcoming cessation of LIBOR (and other IBORs).[1] The CFTC is soliciting information and comment on, among other issues, whether it should update any of its prior clearing determinations for swaps currently subject to its clearing requirements and whether to subject swaps referencing alternative reference rates to clearing requirements. It also requests more general feedback on swap clearing and LIBOR transition. The requests for information and comment are summarized below.

Comments on the RFI are due to the CFTC sixty days after publication in the *Federal Register*. For members of ICI's LIBOR Transition Working Group, we will discuss potential comments on the RFI on the next working group call on Wednesday, December 1. For members of ICI's Derivatives Markets Advisory Committee, we will discuss potential comments on the RFI at the next virtual DMAC meeting on Wednesday, December 15. Please be prepared to provide your feedback on the RFI during these calls or reach out to us directly if you have comments.

Background on Clearing Requirements

The Commodity Exchange Act (CEA) requires that a swap be cleared through a derivatives clearing organization (DCO) if the CFTC determines that the swap, or group, category, type, or class of swap, is required to be cleared, unless an exception to the clearing requirement applies. There are two paths for the CFTC to issue a clearing requirement determination: (i) under Section 2(h)(2)(A) of the CEA, the CFTC may issue a clearing requirement determination based on a CFTC-initiated review of a swap; or (ii) under Section 2(h)(2)(B) of the CEA, the CFTC may issue a clearing requirement determination based on a swap submission from a DCO. In making a clearing requirement determination, the CFTC must consider:

- The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;
- 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;
- 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;
- The effect on competition, including appropriate fees and charges applied to clearing; and
- 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.

The CFTC has applied these factors in issuing two clearing requirement determinations: (i) in 2012 for certain credit default swap indexes, and interest rate swaps in four currencies and in four classes,[2] and (ii) in 2016 for interest rate swaps in nine additional currencies.[3] These clearing determinations include a number of swaps that reference IBORs, including swaps in multiple currencies in each of the fixed-to-floating swap, basis swap, and FRA classes that refer to LIBOR.[4]

Background on LIBOR Transition

Since the CFTC made its clearing requirements determinations for certain swaps that reference IBORs, global regulators have announced dates for certain LIBOR rates or other IBORs to cease or become unrepresentative, including:

- EUR LIBOR in all tenors, as of December 31, 2021;
- CHF LIBOR in all tenors, as of December 31, 2021;
- JPY LIBOR in the spot next, 1-week, 2-month, and 12-month tenors, as of December 31, 2021.The UK Financial Conduct Authority (FCA) determined that JPY LIBOR in 1-month, 3-month, and 6- month tenors would be unrepresentative as of that date, but will require those tenors to continue to be published using a synthetic methodology through 2022;[5]
- GBP LIBOR in the overnight, 1-week, 2-month, and 12-month tenors, as of December 31, 2021. The FCA determined that GBP LIBOR in 1-month, 3-month, and 6- month tenors would be unrepresentative as of that date, but will require those tenors to continue to be published using a synthetic methodology through 2022;[6] and
- USD LIBOR in the 1-week and 2-month tenors, as of December 31, 2021. USD LIBOR in the overnight and 12-month tenors will cease after June 30, 2023, and the 1-month, 3-month, and 6- month tenors would be unrepresentative after that date.

In anticipation of these dates, regulators and market participants globally have identified alternative reference rates to replace LIBOR and other IBORs before they cease or become unrepresentative. For example, in the US, the Alternative Reference Rates Committee (ARRC), a body of market participants and regulators, identified SOFR as its recommended alternative to USD LIBOR.[7] Further, other industry groups have made efforts to advance the transition from LIBOR, such as ISDA's updates to its standard documentation to reflect benchmark reforms.[8]

Current Status of Clearing of Alternative Reference Rate Swaps

The CFTC notes its obligation under Dodd-Frank to coordinate with non-US regulators in establishing consistent international standards for swaps, and that both the Bank of England[9] and the European Securities Markets Authorities (ESMA)[10] have sought changes to their clearing obligations in anticipation of the cessation or unrepresentativeness of certain LIBORs or other IBORs.

The CFTC also acknowledges that DCOs have begun to transition their product offerings to assist clearing members with the process of transferring positions from IBORs and to clear some swaps in SOFR or other alternative reference rates. Certain DCOs have also transitioned outstanding cleared IBOR-linked products to market standard risk-free rate OIS through conversion events prior to the cessation of certain IBORs.

The CFTC observes that certain currency and rate pairs have seen more activity in alternative reference rates than others. It notes that, although SOFR products trading doubled from 2019 to 2020, it remains at low levels,[11] and that the decline in SOFR trading after the October 2020 discounting event shows that market participants were able to use SOFR derivatives when needed, but have not continued to use SOFR and instead have reverted to USD LIBOR. The Commission notes that, based on swap transaction data from January 2021 to October 2021, its staff has estimated that over 90% of the volume of fixed-to-floating swaps referencing USD SOFR, GBP SONIA, CHF SARON, JPY TONA, and EUR ESTR has been cleared on a voluntary basis.[12]

Requests for Information and Comment

The CFTC provides several sets of requests for information and comment aimed at DCOs, their clearing members, swap dealers, and other market participants.

The CFTC requests information from DCOs regarding their ability to (i) continue clearing swaps that reference IBORs after the cessation dates of those reference rates, and (ii) clear swaps that reference an alternative reference rate that are not currently subject to the clearing requirement.[13]

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. The CFTC includes the following specific requests for comment:

Current Swap Clearing Requirement-Related Questions

1. Are market participants concerned about access to clearing for certain swaps that are subject to the Clearing Requirement? If so, are there any Commission actions or regulatory amendments that could facilitate the IBOR transition for market participants?
2. Please discuss recommendations for how the Commission should modify its Clearing Requirement under Commission regulation 50.4 and any related advantages or disadvantages (including anticipated costs) that might be expected from a specific approach.
3. More specifically, should the Commission 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, please discuss a potential timeline for considering and adopting a modification and the reasons for adopting such timeline.

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

Swap Clearing Requirements for Alternative Reference Rates

5. Are market participants concerned about access to clearing for certain swaps that reference alternative reference rates and are not currently subject to the Clearing Requirement? If so, please explain current or anticipated barriers to clearing swaps in alternative reference rates.
6. Are there any steps related to the SOFR transition that have not been completed that would enable a significant number of market participants to submit swaps referencing SOFR to clearing? Are there specific metrics or products associated with the new SOFR rate that need to be developed before swaps referencing SOFR can be used by a broad range of market participants?
7. Would requiring the clearing of swaps referencing SOFR or other alternative reference rates that are not currently subject to the Clearing Requirement affect the ability of a DCO to comply with the CEA's core principles for DCOs?
8. Are there specific data the Commission should consider in determining whether significant notional amount and liquidity exists in swaps referencing SOFR or other alternative reference rates that are not currently subject to the Clearing Requirement?
9. Are there 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 be subject to the clearing requirement?
10. Have market participants 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?
11. Is there adequate pricing data for DCO risk and default management of swaps referencing SOFR? Why or why not?
12. What are the challenges that DCOs may face or have faced in accepting new SOFR swaps or swaps referencing other alternative reference rates for clearing that are not currently subject to the Clearing Requirement from a governance, rule framework, operational, resourcing, or credit support infrastructure perspective?
13. Would requiring the clearing of swaps referencing SOFR mitigate systemic risk? Please explain why or why not and provide supporting data.
14. Would requiring the clearing of swaps referencing SOFR increase risk to DCOs? If so, are DCOs capable of managing that risk? Please explain why or why not and provide supporting data.
15. Would adopting a clearing requirement for swaps referencing SOFR or other alternative reference rates that are not currently subject to the Clearing Requirement materially and beneficially affect trading activity in those swaps?
16. How and when should the Commission evaluate whether to require 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, are there 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?

17. Would adopting a clearing requirement for a new product that references an alternative reference rate, or expanding the scope of the Clearing Requirement to cover additional maturities, create conditions that increase or facilitate an exercise of market power over clearing services by any DCO that would: (i) adversely affect competition for clearing services and/or access to product markets for swaps referencing alternative reference rates (including conditions that would adversely affect competition for these product markets and/or increase the cost of such swaps); or (ii) increase the cost of clearing services? Please explain why or why not and provide supporting data.
18. What new information, if any, should the Commission consider as it prepares to review whether interest rate swaps linked to the alternative reference rates should be subject to a clearing requirement? Are there 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?

New Swap Product Documentation

19. With respect to all new swap products, including those referencing alternative reference rates, is there additional documentation that the Commission should require DCOs to submit with swap submissions beyond the documentation that Commission regulation 39.5 currently requires?

Swap Clearing Requirement Specifications

20. The Commission recognizes that at this time a majority of the swaps subject to the Clearing Requirement fall within the fixed-to-floating swap class. That may change as new alternative reference rates are adopted and will be characterized as OIS or other types of swaps. Should the Commission designate any additional classes of swaps or specifications for purposes of classifying swaps under Commission regulation 50.4? Do DCOs or market participants have suggestions about how to reorganize or structure the classes of swaps subject to the clearing requirement under Commission regulation 50.4? Should the Commission include a new class covering variable notional swaps as a table under Commission regulation 50.4(a)?

Cost-Benefit Considerations

21. The Commission requests comment from DCOs and market participants on the nature and extent of any operational, compliance, or other costs they may incur as a result of potential changes to the Clearing Requirement in response to the market-wide shift to alternative reference rates. Please provide supporting data.

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endnotes

[1] See Swap Clearing Requirement Amendments to Account for the Transition from LIBOR and Other IBORs to Alternative Reference Rates (Nov. 17, 2021), available at https://www.cftc.gov/media/6741/federalregister111721/download.

[2] Specifically, fixed-to floating swaps; basis swaps; forward rate agreements (FRAs); and overnight index swaps (OIS). See Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule, 77 Fed. Reg. 74284 (December 13, 2012) ("2012 Determination"), available at https://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/ClearingRequirement/index.htm. These four classes of interest rate swaps, along with their specifications, are set forth in CFTC regulation 50.4.

[3] See Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps; Final Rule, 81 Fed. Reg. 71202 (October 14, 2016) ("2016 Determination"), available at https://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/ClearingRequirement/CDFClearingReq.html.

[4] Specifically, the 2012 Determination covered certain interest rate swaps in each of these classes referencing LIBOR in three currencies: US dollars (USD), British pounds (GBP), and Japanese yen (JPY). The 2016 Determination covered certain fixed-to-floating interest rate swaps referencing LIBOR in Swiss francs (CHF).

[5] See ICI Memorandum No. 33797 (October 1, 2021), available at https://www.ici.org/memo33797.

[6] The FCA confirmed that it would require LIBOR's administrator to continue publishing GBP and JPY LIBOR in the 1-, 3-, and 6-month tenors, using a synthetic methodology based on term risk-free rates, through 2022.

[7] See RFI at pp.13-14, for a table presenting the alternative reference rates recommended for LIBORs and other IBORs in other currencies.

[8] These updates include a Fallbacks Supplement for new cleared and uncleared derivatives and a Fallbacks Protocol, upon agreement of counterparties to existing uncleared derivatives. See ICI Memorandum No. 32857 (October 23, 2020), available at https://www.ici.org/memo32857.

[9] The Bank of England issued a final policy statement on September 29, 2021. See Bank of England, Derivatives clearing obligation - modifications to reflect interest rate benchmark reform: Amendments to BTS 2015/2205 (September 29, 2021), available at https://www.bankofengland.co.uk/paper/2021/derivatives-clearing-obligation-modifications-to-reflect-interest-rate-benchmark-reform.

[10] ESMA issued a consultation on draft regulatory standards on July 9, 2021. See ESMA, Consultation Paper: On the clearing and derivative trading obligations in view of the

benchmark transition (July 9, 2021), available at https://www.esma.europa.eu/sites/default/files/library/consultation_paper_on_the_co_and_dto_for_swaps_referencing_rfrs.pdf.

[11] RFI at 29.

[12] RFI at text accompanying n.100.

[13] These questions are set out at pp. 33-35 of the RFI.