

## **ARRC – Areas of Significant Concern Regarding CFTC IBOR Transition Relief**

This document sets out requests from the Alternative Reference Rates Committee (**ARRC**) arising from CFTC staff no-action relief provided in connection with the transition away from the London Interbank Offered Rate (**LIBOR**) and other inter-bank offered rates (**IBORs**). They include requests for further clarification and further relief based upon developments since the ARRC submitted its relief request to CFTC staff in late 2019. These requests reflect feedback provided by CFTC staff on the February 25, 2020 call with members of the ARRC Regulatory Issues Working Group (**February 25 Call**).

One of these requests for DCR—regarding the rates covered by DCR’s no-action letter—has since taken on additional urgency because ISDA expects to publish in July 2020 the ISDA 2020 IBOR Fallbacks Protocol, which will facilitate the amendment of swaps to include Fallback Amendments. Lack of relief with respect to the rates covered by the DCR letter may deter market participants from adhering to the ISDA protocol, which would negatively impact the success of IBOR transition efforts.

### *New Relief Request for All Divisions*

***The ARRC requests that the Divisions provide relief for amendments to any term of a swap or related agreements that refers to or is based upon a reference rate, where an amendment to the term is done solely as part of an IBOR transition.***

- Swaps and related agreements may include terms that refer to or are based upon reference rates, other than the reference rate that is the underlying rate of the swap. These rates may need to be replaced in connection with the transition from IBORs to risk-free rates (**RFRs**). Some of these other rates may not be IBORs, impaired rates or any successor rates, but nonetheless would be replaced solely as part of the transition to RFRs.
  - *Example:* Interest rate swaptions are generally valued based on a discount rate used by a derivatives clearing organization (**DCO**). Certain DCOs have announced that they intend to change their applicable discount rate from Fed Funds to SOFR (or from EONIA to ESTR). As a result of this change, the ARRC believes that swaption counterparties may wish to, prior to exercise, amend the swaption’s terms to reflect an agreement regarding the discount curve to be applied for the settlement of the swaption or to compensate for the change in value resulting from the discount rate change at the relevant DCO. These types of amendments are not specifically addressed under the current letters.

- *Example:* The interest rate applicable to cash collateral in a credit support annex (CSA) may be transitioned from an Impaired Reference Rate or other rate (e.g., Fed Funds, EONIA) to an RFR. This transition could be viewed as an amendment to the material terms of a swap and is not explicitly covered by the current relief.
  - Amendments to the interest rates used in CSAs may be driven by the discount rate change implemented by the DCOs 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 may seek to align the rates used in the CSA with the discount rate used by the DCO to avoid basis risk.
- This is an issue that has recently come to the attention of the ARRC and reiterates the need for broad-based, rather than overly prescriptive or specific relief.
- The ARRC requests that all three divisions provide relief for amendments to any term of a swap or documentation underlying or related to a swap that refers to or is based upon a reference rate, where an amendment to the term is done solely as part of an IBOR transition.<sup>1</sup>

### *DCR Letter*

#### **Covered Rates**

The DCR relief currently is available only for legacy interest rate swaps referencing USD LIBOR, JPY LIBOR, GBP LIBOR, CHF LIBOR, and SGD SOR. *The relief should be expanded to cover all rates covered by the DSIO letter, including rates that may be replaced and rates that may be used as permissible fallbacks/replacements. At a minimum, the relief should be expanded to cover all rates covered by the ISDA protocol.*

- If relief is provided only for the rates specified in the DCR letter, market participants may be deterred from engaging in voluntary transition efforts, including through adherence to the ISDA protocol, since such transition efforts could result in legacy swaps being subject to the mandatory clearing requirement.

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<sup>1</sup> The ARRC previously submitted a relief request to the DSIO on this same topic. *See* Alternative Reference Rates Committee Letter to DSIO 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 (June 16, 2020), *available at* [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC\\_CFTC\\_DSIO\\_Swapoptions\\_Relief\\_Request\\_Letter.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_CFTC_DSIO_Swapoptions_Relief_Request_Letter.pdf). The ARRC continues to request the relief in its June 16 letter to DSIO; this present ARRC Regulatory Issues Working Group Issues List does not replace the June 16 letter but for completeness includes the request related to the DCO discount rate change.

- *Example:* The relief does not cover EURIBOR, which is included in the types of rates subject to a clearing mandate. While EURIBOR is not expected to cease at present time, the ISDA protocol will create fallbacks for EURIBOR as part of the larger industry movement from IBORs to RFRs. Absent an expansion of the relief, a market participant with EURIBOR legacy swaps may be hesitant to adhere to the ISDA protocol because adherence would result in Fallback Amendments being made to such swaps, which could trigger the mandatory clearing requirement.
- Providing relief for all rates covered by the DSIO letter would not seem to present additional meaningful risks or evasion concerns, given that the relief would continue to be available only for legacy swaps and would be limited to IBORs and other Impaired Reference Rates, as defined in the DSIO letter. In addition, the relief currently specifies that it is available only where the legacy swap is “amended for the sole purpose of changing the floating rate fallback provisions,” which effectively addresses evasion concerns.
- In addition, adjusting the relief to address all rates covered by the DSIO letter or, at a minimum, the rates covered by the ISDA protocol, would avoid the need for what the ARRC anticipates may be further, frequent modifications of the DCR letter to accommodate changes made to the ISDA protocol, including those made at the direction of regulators.
  - *Example:* The relief covers the Fallback Amendment of SGD SOR-VWAP to SORA. However, the Steering Committee for SOR Transition to SORA (SC-STS), an industry-led body established by the Monetary Authority of Singapore to oversee the transition from SOR to SORA, recently directed ISDA to use “Adjusted SOR” as the fallback for SOR in the Supplement to the 2006 ISDA Definitions and in the ISDA protocol, rather than SORA. As a result, this aspect of the relief is already outdated. Such specificity in relief is likely to result in further future gaps, which result in the same friction to transition that the letter is meant to address.

### Replacement Rate Amendments

The DCR letter currently provides relief only for Fallback Amendments, not for Replacement Rate Amendments. ***The relief should be expanded to cover Replacement Rate Amendments. In addition, as is contemplated in the DSIO letter, the relief provided for Replacement Rate Amendments should permit (i) extensions of maturity of a swap or a portfolio of swaps necessary to accommodate the differences between market conventions for an Impaired Reference Rate and its replacement and (ii) increases in the total effective notional amount of a swap or the aggregate total effective notional amount of a portfolio of swaps necessary to accommodate the differences between market conventions for an Impaired Reference Rate and its replacement.***

- The DCR letter currently provides relief only for Fallback Amendments, not for Replacement Rate Amendments.
- DCR staff stated on the February 25 Call that, in their view, relief for Replacement Rate Amendments is unnecessary because only floating-to-floating legacy swaps—and not fixed-to-floating legacy swaps—that are transitioned to SONIA would become subject to the mandatory clearing requirement. Moreover, there may not be sufficient number of such legacy swaps outstanding to warrant relief. The treatment of legacy IBOR swaps transitioned to Fed Funds under a Replacement Rate Amendment, which could be subject to mandatory clearing, was not specifically discussed on that call.
- The ARRC respectfully disagrees with the view expressed by DCR staff. A legacy fixed-to-floating IBOR swap that is transitioned to SONIA or Fed Funds could become subject to mandatory clearing as an interest rate swap in the overnight index swap (OIS) class under CFTC Rule 50.4. The OIS class includes “[s]waps for which one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate based on a daily overnight rate.” *See* 77 Fed. Reg. 74283 at 74302 (Dec. 13, 2012).
- We urge DCR to expand its relief to Replacement Rate Amendments, so that relief will be available to legacy IBOR swaps converted to alternative risk free rates that are subject to mandatory clearing—currently, SONIA or Fed Funds in the OIS category.
  - The absence of relief for Replacement Rate Amendments creates precisely the hurdles to a transition that the relief is meant to avoid. For example, it could deter market participants from taking early, voluntary steps to transition such legacy swaps. It also causes uncertainty as to whether the dealer would be required to obtain new end-user exception representations.
- In addition, the DSIO Letter contemplates that Replacement Rate Amendments may occur in several different ways to address the needs of various swap counterparties, including, for example, by way of execution of new contracts in replacement of and immediately upon termination of existing contracts (i.e., tear-ups). The ARRC requests that the DCR letter be modified to include this same clarification.

#### **Ancillary Modifications**

The DCR letter does not address ancillary modifications to swaps. *The ARRC requests that the DCR letter be updated to include the same clarifications as are in the DSIO letter, to ensure that different standards are not applied to the same swaps under the letters and to provide helpful certainty as market participants structure transitions of their swaps and swap portfolios.*

- The DSIO letter contemplates that Fallback Amendments and Replacement Rate Amendments may require various follow-on amendments to maintain the economics of a swap.
  - *Examples:* These may include spread adjustments resulting from a transition from a term rate to an overnight rate, from unsecured to secured, or from a change in tenor. They may also include other ancillary changes to existing trade terms to account for different market conventions for the alternative rate as compared to the rate that is being replaced, for example, different reset dates, fixed/floating leg payment dates, business day conventions and day count fractions.
- To ensure that counterparties do not use the relief as an opportunity to renegotiate economic terms or otherwise engage in price-forming activity, the DSIO letter generally provides that the relief is not available for any amendment that (i) extends the maximum maturity of a swap or a portfolio of swaps beyond what is necessary to accommodate the differences between market conventions for an Impaired Reference Rate and its replacement, or (ii) increases the total effective notional amount of a swap or the aggregate total effective notional amount of a portfolio of swaps beyond what is necessary to accommodate the differences between market conventions for an Impaired Reference Rate and its replacement.
- The ARRC requests that the DCR letter be modified to clarify that these same ancillary modifications to swaps would be permitted.

### **End User Relief<sup>2</sup>**

The relief for end users is overly narrow and prescriptive and will deter end users from engaging in transitions of their hedging transactions. In addition to the expanded relief for covered rates and Replacement Rate Amendments described above:

- ***The relief should not be conditioned on end-users amending the cash positions being hedged by 12/31/21. End users will be reluctant to amend a hedging transaction before 12/31/21 if they are unsure they can amend the corresponding agreement with the underlying commercial exposure before that date.***
- ***DCR should clarify that it does not expect counterparties to monitor end-users' compliance with any conditions in the DCR letter or the end user exception on an ongoing basis.***
- ***The letter should provide relief to entities that relied on the end-user exception at the time of entering into a swap but would no longer be eligible for such exception (e.g., a bank that previously had total assets of \$10 billion or less, and that now exceeds that threshold).***

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<sup>2</sup> In addition to the requests discussed herein, the ARRC would like to reiterate a request that it has previously discussed with CFTC staff—specifically, that CFTC staff should issue interpretive guidance,

### **Covered Rates and Replacement Rate Amendments**

- The letter provides relief related to Subpart C of Part 50 (the end-user clearing exception) only where: (a) a *swap* or *relevant commercial agreement* is amended by execution of a Fallback Amendment; (b) an existing fallback provision in a *commercial agreement* is triggered because the floating rate is unavailable, is permanently discontinued or has been determined to be non-representative by the benchmark administrator or relevant authority; or (c) the floating rate in a *commercial agreement* has been amended to an applicable RFR (emphasis added).
- As described above, the relief for all swap market participants—including end users—should be available for Replacement Rate Amendments and for all rates covered by the DSIO letter.
  - In other words, if an end user previously relied on the end-user exception when entering into an IBOR swap to hedge a commercial agreement, it should be able to continue to rely on that exception if it replaces the IBOR with an alternative reference rate (e.g., SONIA or Fed Funds), even if the end user has not yet amended the underlying commercial agreement that is being hedged.

### **Amendments to Cash Positions**

- The DCR letter requires end users to amend cash positions being hedged, to reflect changes to reference rates in the associated hedging swaps, by 12/31/21.
- While we recognize that cash contracts referencing LIBOR will need to be amended, the end-user exception relief should not be conditioned on such amendments and should not impose a separate deadline of 12/31/21.
  - As recognized by the letter, end users may be unable to simultaneously amend cash positions and the swaps hedging such positions.
  - Imposing a deadline for amendment of cash positions could deter end users from taking early steps to transition their IBOR-based

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rather than no-action relief, with respect to the issues involving end users. We understand that CFTC staff have suggested that they believe that interpretive guidance would not be appropriate in this context; however, the ARRC respectfully requests that this issue be reconsidered, and would be happy to provide further background on why no-action relief, as opposed to interpretive guidance, would be problematic for end users, who would benefit from more formal action clarifying staff's views of the requirements of the CEA and regulations thereunder.

agreements (e.g., by opting into the ISDA protocol) if they are unsure of their ability to complete conforming amendments to contracts with the underlying exposures by that deadline. Aligning cash positions with swaps by this deadline may be particularly difficult for end users that elect to transition their swaps or enter into new swaps near the end of 2021.

- *Example:* An end user may have a commercial agreement with multiple parties, such as a loan agreement made with a syndicate, yet execute an interest rate swap hedging that agreement with only one or a subset of those parties. In such a case, it may be more difficult to amend the loan agreement than to amend the swap.
- As an alternative to simply removing the requirement to amend cash positions by 12/31/21, and to address DCR's concern that swaps won't align with underlying cash positions, the DCR letter could instead impose an obligation that entities engage in good faith efforts to amend their cash positions or swaps.

### **Ongoing Monitoring of End User Conditions**

- The DCR letter implies that market participants must monitor the availability of the end user exception on an ongoing basis. The letter states that “both commercial end-users and cooperatives are subject to an ongoing obligations under CFTC regulations to maintain eligibility to elect an exception or exemption from the clearing requirement.”
- This statement seem inconsistent with past statements of the CFTC regarding the operation of the end-user exception. For example, in adopting the end-user exception, “The Commission confirm[ed] that counterparties should look to the facts and circumstances that exist at the time the swap is executed to determine whether a swap satisfies the criteria for hedging or mitigating commercial risk . . . . The Commission notes that nothing in [§ 50.50] would require ongoing reporting or testing of a swap's hedge effectiveness.” 77 Fed. Reg. 42560, 42572 (July 19, 2012); *see also id.* at 42575–76.
- While swap counterparties are generally required to have a reasonable basis to believe that an end user meets the conditions required to rely on the end-user exception (*see* CFTC Rules 23.505(a) and 50.50(b)(3)), this requirement applies at the time a swap is entered into. *See* 77 Fed. Reg. at 42575 (“The Commission has also determined that parties will not be required to demonstrate hedge effectiveness or engage in periodic hedge effectiveness testing. The Commission agrees with commenters that entities need to know whether the swap is eligible for the end-user exception at the time it is executed and should not be subject to second guessing if subsequent hedge effectiveness testing finds that the swap does not, over time, hedge the

intended risk as such ineffectiveness may be beyond the control of the electing counterparty.”).

- DCR should clarify that it does not expect end users or their counterparties to monitor end users’ compliance with the conditions for the relief provided to end users under the DCR letter and that a counterparty to an end user can continue to rely on representations regarding an end user’s ability to rely on an exception or exemption from the clearing requirement.

### **Relief Related to Changes in Eligibility for the End-User Exception**

- The letter does not directly address the situation in which an entity that relied on the end-user exception at the time of entering into a swap would no longer be eligible for such exception (e.g., a bank that previously had total assets of \$10 billion or less, and that now exceeds that threshold). Instead, with respect to changed eligibility, the relief is solely available in situations where the transition from an IBOR to an RFR causes an end user not to qualify for the “hedge or mitigate commercial” risk requirement of the end-user exception, and does not recognize relief for if compliance with other elements of the end-user exception change.
- Entities with changes to their end-user exception eligibility criteria may be hesitant to transition their IBOR swaps to RFR swaps to the extent that transitioning those swaps would trigger mandatory clearing requirements. These entities could be particularly hesitant to enter into the ISDA protocol, which could trigger clearing requirements for a large number of IBOR swaps all at once.
- We request that DCR clarify that such entities would be eligible for relief under this letter.

### **Covered Swaps**

The DCR relief currently is drafted with respect to interest rate swaps only. ***The relief should be expanded to cover credit default swaps as well, which similarly may reference IBORs and need to be converted to RFRs.***

- The DCR letter currently focuses on relief for interest rate swaps under the mandatory clearing requirement. However, certain credit default swaps that reference IBORs and need to be converted to RFRs are also subject to the clearing requirement.
- DCR should expand its relief to cover credit default swaps in addition to interest rate swaps.

### ***DMO Letter***

The DMO letter appropriately provides relief from the trade execution requirement for Fallback Amendments, Replacement Rate Amendments, and New RFR Swaps (termed IBOR Transition Mechanisms, as described in the letter). ***DMO should further clarify, to ensure that its relief is consistent with that provided by DSIO, that relief is available: (i) for IBOR Transaction Mechanisms that extend the maximum maturity or increase the total effective notional amount of a swap or a portfolio of swaps if necessary to accommodate the differences between market conventions for an Impaired Reference Rate and its replacement; and (ii) where the parties make multiple amendments to the same swap or portfolio of swaps before settling on an alternative benchmark that adequately meets the counterparties' commercial needs (i.e., multi-step conversions).***

- The DSIO letter makes clear that relief would be available: (i) for Qualifying Amendments that extend the maximum maturity or increase the total effective notional amount of a swap or a portfolio of swaps if necessary to accommodate the differences between market conventions for an Impaired Reference Rate and its replacement; and (ii) where the parties make multiple amendments to the same swap or portfolio of swaps before settling on an alternative benchmark that adequately meets the counterparties' commercial needs (i.e., multi-step conversions).
- DMO should confirm that relief under its no-action letter would also be available in such circumstances.

### ***DSIO Letter***

#### **ECP Requirements**

The DSIO letter currently provides relief for swap dealers from the requirement in CFTC Rule 23.430 for a swap dealer to verify whether its swap counterparty is an eligible contract participant (ECP) and relief for natural person ECPs from qualifying under the definition of ECP under CEA 1a(18)(A)(xi) in connection with Qualifying Amendments. ***The letter should be expanded to provide relief from (i) CEA Section 2(e), which generally makes it unlawful for a non-ECP to enter into a swap and (ii) to expand the relief under the ECP definition to all types of ECPs, not only natural person ECPs.***

- The DSIO letter provides relief from Rule 23.430 (verification of counterparty eligibility) and from a failure to qualify as an ECP under CEA Section 1a(18)(A)(xi) (Natural Person ECPs) solely to the extent such status is relevant as a consequence of a Qualifying Amendment to an uncleared swap.

- DSIO should also provide relief from CEA Section 2(e) generally, which makes it unlawful for any person that is not an ECP to enter into a swap unless it is entered into on or subject to the rules of a designated contract market.
- In addition, the relief provided under the ECP definition in CEA 1a(18) should be extended to all types of ECPs, such that it covers more than natural person ECPs.

### Pre-Trade Mid-Market Marks

*The DSIO letter should provide relief for swap dealers from the requirement to provide a pre-trade mid-market mark for Qualifying Amendments.*

- The DSIO letter provides helpful relief for many swap dealer external business conduct requirements in connection with Qualifying Amendments to legacy swaps.
  - We agree that it is appropriate for swap dealers to provide risk and characteristics disclosure as required under 23.431(a)(1), (2) and (3)(ii) in advance of a Qualifying Amendment, even for these legacy swaps.
- However, the ARRC requests relief from the requirement to provide a pre-trade mid-market mark as required under 23.431(a)(3)(i), given that neither the Fallback Amendments nor Replacement Rate Amendments are expected to significantly change the price of swaps and therefore a pre-trade mid-market mark would not provide the counterparty with any useful information. Providing a pre-trade mid-market mark may be particularly challenging with respect to Fallback Amendments effected through the ISDA protocol, since the swap dealer is unlikely to know in advance when their counterparties intend to adhere.

### Confirmation Requirements

The DSIO letter provides relief from the confirmation requirement of CFTC Rule 23.501 for Qualifying Amendments made pursuant to a multilateral protocol. *The letter should clarify that the relief would also be available for Qualifying Amendments for legacy swaps made pursuant to a bilateral agreement.*

- The DSIO letter provides relief from the confirmation requirement of CFTC Rule 23.501 associated with any Qualifying Amendment to an uncleared swap, “provided that the amendment is accomplished pursuant to a multilateral protocol.” In restating ARRC’s request for relief, the letter states, “[g]iven that through adherence to a protocol, multiple swaps could be legally amended, and confirmed, simultaneously, ARRC seeks confirmation that swap dealers will not

be required to issue new confirmations for STRD Legacy Swaps and Pre-Transition Swaps that are amended via a multilateral protocol.”

- We request that DSIO clarify that relief from the confirmation requirements of CFTC Rule 23.501 would also be available for Qualifying Amendments made pursuant to bilateral agreements that would amend multiple swaps, in addition to Qualifying Amendments made pursuant to a multilateral protocol. Some market participants may wish to enter into bilateral agreements that would amend multiple swaps, in lieu of adhering to a multilateral protocol (e.g., a bilateral agreement that would add fallback amendments into a portfolio of swaps).
- These bilateral agreements would function similarly to the multilateral protocol, in that they would result in a simultaneous amendment and confirmation of a portfolio of swaps. Thus, the ARRC believes that the relief from the confirmation requirements should be expanded to cover Qualifying Amendments, whether made on a multilateral or bilateral basis.

### **Bilateral Conversions Across Different Swap Dealers**

*The DSIO letter should be clarified to explicitly permit bilateral conversions of a swap portfolio in which the number of swap dealers is changed, but not necessarily reduced to one.*

- Example 6 on page 6 of the DSIO letter explicitly permits bilateral conversions of a swap portfolio referencing an Impaired Reference Rate involving multiple swap dealers to a portfolio referencing an alternative reference rate with a single swap dealer. However, the example does not explicitly address bilateral conversion in which the number of swap dealers is changed, but not reduced to one.
- For the avoidance of doubt, the ARRC requests that Example 6 be modified to more clearly cover a conversion where the resulting swaps would be with more than one dealer. We recognize that the example would not address conversions that result in a counterparty establishing relationships with new swap dealer entities, even if within the same group as a swap dealer with which the party has one or multiple swaps.

### **Relief under the Basis Swap Method**

*DSIO should clarify that increases in maximum maturity or the total effective notional amount of a swap or a portfolio of swaps, if necessary to accommodate the differences between market conventions for an Impaired Reference Rate and its replacement, is permitted under the Basis Swap Method to the same extent as for Qualifying Amendments.*

- Condition 3 to the relief for the Basis Swap Method limits the relief as follows: “The basis swap does not have the effect of extending the maximum maturity or

increasing the aggregate total effective notional amount of the referenced CFTC Margin Rule Legacy Swap(s).”

- The DSIO provides for relief for Qualifying Amendments so long as extensions of maximum maturity and increases in aggregate total effective notional amount are not “beyond what is necessary to accommodate the differences between market conventions for an IRR and its replacement.”
- For similar reasons as to why Qualifying Amendments may necessitate extensions in maturity and increases in notional—differences in market conventions for Impaired Reference Rates and their replacements, and the possibility that liquidity for alternative rates will develop differently at different ends of the maturity spectrum—the Basis Swap Method may also necessitate extensions in maturity and increases in notional.
- We request that DSIO amend the relief in the DSIO letter for the Basis Swap Method to permit the same types of extensions of maturity and increases in notional as permitted in the relief provided for Qualifying Amendments.

#### **End-User Relief**

As with the DCR letter, the relief for end users in the DSIO letter is overly narrow and prescriptive and will deter end users from engaging in IBOR transitions.

*The relief should not be conditioned on end-users amending cash positions being hedged by 12/31/21.*

- Please see the discussion on end user issues in the DCR letter section, above.