

Chatham Financial (“Chatham”) thanks the Alternative Reference Rates Committee (ARRC) for the opportunity to comment on this consultation “Regarding More Robust LIBOR Fallback Contract Language for New Issuances of LIBOR Floating Rate Notes.”

Chatham is the largest advisor and technology provider to derivatives end users, serving over 2,000 clients worldwide. Chatham serves both financial end users, including regional and community banks, and non-financial end users, touching virtually every segment of the economy.

Chatham undertakes a wide range of activities that make us intimately familiar with the impact of LIBOR transition on both derivatives and cash products. These activities include helping our clients hedge more than \$2 billion notional per day, providing systems and software that amongst other things calculates payments and values debt and derivative positions, and providing accounting, regulatory and capital raising advisory services.


Chatham appreciates the difficulty of transitioning to risk free rate (RFR) alternatives from interbank offer rates (IBORs) and supports efforts to ensure that these alternatives are robust and not readily susceptible to manipulation. In making this transition, it is important to note that, for end users, there are substantial costs and risks to transitioning to a cash and derivatives market that does not allow matching term rates for cash and derivatives instruments. Current market practices and systems are predicated upon the availability of term rates for cash and derivative instruments in both markets.

While Chatham recognizes that this consultation is regarding fallback provisions for Floating Rate Notes (FRNs), it is not possible for end users to consider fallback language for FRNs separately from fallbacks for derivatives. At a practical level, since term rates are contemplated for cash instruments, end users’ best option for hedging will be to seek to negotiate term rates for derivative contracts, provided they exist. This is true regardless of whether the International Swaps and Derivatives Association (ISDA) provides for term rates in their model protocols. In our view, ISDA documentation is best intended to facilitate transactions given market structure, not force market structure to fit certain transactions.

While Chatham strongly supports and commends the ARRC for including term rates in the proposed fallback language for FRNs, Chatham recommends that the ARRC and ISDA recognize the reality that, if term rates exist for cash instruments, they will need to be used in derivatives to hedge those instruments. Term rates for derivatives should be encouraged and embraced as a way to avoid the imposition of unnecessary operational and systems costs on market participants.

Chatham understands regulators’ concern over whether the usage of term rates in derivatives contracts will cause term rates for RFRs to be subject to the same flaws that undermined LIBOR. The ARRC, however, appears willing to consider term rates for cash instruments which indicates regulators believe term rates can be designed to minimize their susceptibility to manipulation. Chatham also notes that the U.S. Commodity Futures Trading Commission (CFTC) has the authority to review swaps and futures listed on U.S. exchanges and that one of the core principles for listed products is that they are not readily susceptible to manipulation.

To the extent there are concerns that the potential size of a derivatives market based on term-SOFR rates presents risks echoing current LIBOR markets, Chatham recommends regulators, the ARRC and ISDA consider whether term-SOFR rates for derivatives should at least be encouraged for the hedging of



cash instruments. Chatham also recommends that regulators and the ARRC consider the role that mandatory execution requirements for swaps and futures on trading platforms will play as markets for SOFR-based products mature in providing a robust base of transactions from which term rates can be derived.

As a third-party service and data provider to end users of both cash and derivatives markets, Chatham now provides more specific answers to the questions posed by the ARRC.

Questions about Pre-cessation Triggers

Question 1(a): *Should fallback language for FRNs include any of the pre-cessation triggers (triggers 3, 4 and 5)? If so, which ones?*

Triggers 3, 4 and 5 address potential scenarios where LIBOR is unavailable or has degraded to a point where it is no longer fit for purpose. These triggers could be useful additions to FRN fallback provisions if agreed to by lender and borrower. In particular, Trigger 3 provides a useful backstop, addressing a situation where LIBOR has not been published for 5 days, but the other pre-cessation events have not been triggered. However, in such a situation, Chatham would expect either the benchmark supervisor or administrator to take appropriate action or make appropriate announcements.

Question 1(b): *Please indicate whether any concerns you have about these pre-cessation triggers relate to differences between these triggers and those for standard derivatives or relate specifically to the pre-cessation triggers themselves.*

Differences in the triggers expose end users to basis risk when the cash instrument and derivative fall back at different times and/or fall back to different rates and spread adjustments. Derivatives and cash instruments are inextricably linked economically. This risk can be mitigated through the renegotiation of the derivative contract at the time that the cash instrument triggers are met.

In addition to the economic impact of differences in triggers, there are potential accounting risks. Basis differences such as this require much more rigorous accounting techniques, and many hedging relationships have been set up to use more simplistic techniques. Chatham is aware that the Financial Accounting Standards Board (FASB) is considering transition relief in this area, but there is currently uncertainty as to the content and timing of such relief. Chatham strongly recommends the ARRC, ISDA and FASB harmonize approaches to IBOR fallbacks to minimize the potential for market disruption.

Question 1(c): *If pre-cessation triggers are not included, what options would be available to market participants to manage the potential risks involved in continuing to reference a Benchmark whose regulator has publicly determined that it is not representative of the underlying market or a Benchmark permanently or indefinitely based on a number of submissions that the Benchmark's administrator acknowledges to be insufficient to allow for production in a standard manner?*

Any options to manage such risk would have to be found in contract law, existing contract terms, or negotiations between lender and borrower.

Questions about Replacement Benchmarks

Question 2: *If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for floating rate notes referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR?*

Chatham believes that the forward-looking term rate should be the primary fallback for FRNs. Given the operational difficulties of incorporating non-term rates, Chatham would expect term rates to also be the first fallback for derivatives hedging cash instruments. If standard ISDA documentation did not include a term rate that was referenced in an FRN, end users would seek to negotiate an amendment

incorporating the FRN rate as the first fallback for the hedging instrument. If term rates exist and are sufficient for incorporation into cash instruments, it would be difficult not to incorporate them into derivatives hedging those cash instruments.

Question 3(a): *Should Compounded SOFR be the second step in the waterfall? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?*

Chatham agrees with Compounded SOFR as the second step in the waterfall. For the purpose of derivatives used to hedge FRNs, Chatham is not aware of any impediment to adding a term rate as the primary fallback for a swap. ISDA's determination to not include a term-rate fallback would not influence our preference for this being the second step in the waterfall.

Question 3(b): *If you believe that Compounded SOFR should be included, which compounding period is preferable ("in arrears" or "in advance")? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR "in arrears" or "in advance"?*

Compounded setting in arrears is attractive to end users because it reflects the actual rate conditions of the period. Rate movement during the period is appropriately reflected in the cash flows that follow allowing market changes to be reflected in the final rate.

Although a compounded in advanced rate benefits from the ability to reference and quickly reproduce the rate throughout the period, the disadvantage of compounding in advance is that it is backward looking, and thus lagged to the current interest period. This short-coming could result in market participants attempting to manipulate the market in their favor if they have a view or expectation of where rates will go. For example, if the market anticipates a rate hike during an upcoming period, a borrower would be incented to draw more money on a revolving credit facility at the previous lower rate because the increase in interest rates would not be reflected until the next reset date. A forward-looking methodology will eliminate these concerns because the anticipated rate hike already will be incorporated into the rate.

Despite the resulting operational challenges, across instruments impacted by the transition away from LIBOR, Chatham recommends the use of a compounded in arrears rate over a compounded in advance rate.

Questions 4(a)-(b): *Would an overnight rate that remains in effect for the entire interest period be an acceptable option for investors, issuers and agents? Should the waterfall include Compounded SOFR (step 2) and spot SOFR (step 3) and/or a simple average of SOFR (not in the waterfall at this time)? If only one of these options is included, which is preferable? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?*

Generally, Chatham accepts the waterfall as-is, however, a spot rate is lacking in economic soundness as it is a rate designed only to be applied to an overnight period. Given the inherent simplicity, Chatham has not completely ruled out spot SOFR, though it has several theoretical shortcomings such as ignoring the inherent variation over different tenors.

Questions 5-7

A replacement rate determined by the Relevant Governmental Body, would be preferred by end users, however, Chatham believes there are problems with the entities included in the Relevant Government Body definition. The Federal Reserve Board of New York is not a government agency and such an important decision should not be left to a committee of either the Federal Reserve Board of Governors or the Federal Reserve Board of New York. Given the great potential for winners and losers, such a decision should only be made by a federal agency with the requisite market expertise such as the Federal Reserve Board of Governors or the US Commodity Futures Trading Commission (CFTC). Any entity whose governance or membership is primarily comprised of non-governmental institutions, including ISDA and ARRC, would have inherent conflicts of interest were they to determine successor rates due to their makeup and governance.

In a situation where there is no SOFR-based fallback rate and the Relevant Governmental Body has not recommended a replacement rate for FRNs, using the fallback set forth in the ISDA Definitions for SOFR-linked derivatives maximizes the potential for eliminating basis risk.

Questions about Replacement Benchmark Spread

Questions 8-10

It could be positive for the ARRC to recommend spread adjustments for consideration by market participants. For the reasons described below, Chatham does not believe spread waterfalls should reference ARRC recommendations. Similarly, Chatham does not think the ISDA fallback rate should be referenced in the spread waterfall at this time. The issuer should not be able to unilaterally determine the spread adjustment; this should be a negotiated item given the uncertainties about how spread adjustments will work for all products and in all market conditions.


Given that significant work remains to be done in defining and operationalizing LIBOR alternative rates, it is premature to recommend specific spread waterfalls. A threshold determination would indicate whether a specific spread methodology can adequately address a reasonable range of market conditions while preserving, to the greatest extent possible the original economics of the contracts being transitioned. Given the unknowns, it is important for end users to maintain the flexibility to find the appropriate spread adjustment rather than be locked into a currently unknown spread adjustment between LIBOR and a currently unknown rate.

Questions 11 and 12 have intentionally been omitted.

Questions about General Feedback

Question 13: *Please provide any additional feedback on any aspect of the proposal.*

While Chatham appreciates the value of legal certainty, given the large number of unknowns regarding transition to LIBOR alternatives, as advisors to end users, Chatham is hesitant to lock into approaches that may provide legal certainty, but would create operational or economic uncertainty if alternative rates or spread adjustments do not behave as expected. Once LIBOR alternative markets and products develop, hardwired approaches that provide legal certainty could be beneficial. Currently, Chatham



believes approaches that maintain the flexibility of end users to play a role in determining rates and spread adjustments in the event of LIBOR unavailability is critical. However, as the market infrastructure develops around SOFR-based rates and products, Chatham expects that hardwired approaches could benefit both end users and dealers. One factor that could facilitate this would be confirming that term rates will be acceptable for derivatives used to hedge cash instruments based on term rates. This would help mitigate the current market uncertainty regarding the management of potential mismatches in rate structure between cash instruments and derivatives discussed above.