



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Market Oversight

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Re: No-Action Relief from Certain Reporting Requirements in Connection with the Transition From Effective Federal Funds Rate to Secured Overnight Financing Rate for Discounting for Certain LCH Limited Cleared Swap Products

Dear Mr. Oliver:

This letter responds to a request for relief from LCH Limited (“LCH”) to the Commodity Futures Trading Commission’s (“CFTC” or “Commission”) Division of Market Oversight (“DMO”).¹ As described in the LCH Letter, on October 16, 2020, as part of an industry-wide initiative to transition swaps that reference the London Interbank Offered Rate (“LIBOR”) to alternative risk-free rates, “LCH intends to change the discounting rate used for USD discounted contracts cleared at its SwapClear service ([“Affected Contracts”] from the [Effective Federal Funds Rate (“EFFR”)] to the Secured Overnight Financial Rate (“SOFR”)....”² As part of the transition process for the Affected Contracts, LCH will employ a compensation mechanism that will create swaps for clearing members and swaps customers that are intended to replicate the discounting risk profile for each portfolio of Affected Contracts immediately following the discounting transition (“Discounting Swaps”).³

According to the LCH Letter, some LCH clearing members and customers would prefer to liquidate these Discounting Swaps. LCH will offer its affected customers “the ability to elect, via their clearing members, to have their Discounting Swaps liquidated through an auction process carried out by LCH on October 16[,], 2020 ([“Auction Date”).”⁴ For all Discounting

¹ LCH, Request for no-action relief from real-time public reporting requirements under 17 CFR § 43.3 (October 6, 2020) (“LCH Letter”).

² *Id.* at 1-2.

³ *Id.* at 2.

⁴ *Id.*

Swaps LCH's that customers elect to have liquidated through the auction process ("Elected Swaps"), LCH will net all of the Elected Swaps with the same maturity⁵ into a single swap ("Auction Swap").

LCH represents that it believes that the unique nature of the auction process and the resulting Auction Swaps will make real-time public reporting of the swap transaction and pricing data for the Auction Swaps operationally difficult for clearing members and LCH to report in the timeframe required in Commission regulation 43.3.⁶ Therefore, LCH is requesting relief from certain real-time reporting requirements in Part 43 to permit delayed reporting of the swap transaction and pricing data for the Auction Swaps for four weeks from the Auction Date.

I. Factual Background

In response to significant concerns regarding the reliability and robustness of the interbank offered rates ("IBORs"), the Financial Stability Board ("FSB") called for the identification of alternative benchmarks to the IBORs and transition plans to support implementation of these alternatives.⁷ The U.S. Financial Stability Oversight Council ("FSOC") has repeatedly called for member agencies to work closely with market participants to identify and mitigate risks that may arise during an IBOR transition process.⁸

In 2014, the Federal Reserve Bank of New York convened the Alternative Reference Rate Committee ("ARRC")⁹ in order to identify best practices for U.S. alternative reference

⁵ The Discounting Swaps will be registered across six maturity buckets: 2Y, 5Y, 10Y, 15Y, 20Y, and 30Y ("Maturity Buckets"). *Id.*

⁶ *See* 17 CFR 43.3(a).

⁷ *See generally* FSB statement, "Interest rate benchmark reform – overnight risk-free rates and term rates" at 1, (July 12, 2018), available at: <https://www.fsb.org/wp-content/uploads/P120718.pdf> ("Because derivatives represent a particularly large exposure to certain IBORs, and because these prospective RFR-derived term rates can only be robustly created if derivatives markets on the overnight RFRs are actively and predominantly used, the FSB believes that transition of most derivatives to the more robust overnight RFRs is important to ensuring financial stability."); FSB Reforming Major Interest Rate Benchmarks (July 22, 2014), available at: https://www.fsb.org/wp-content/uploads/r_140722.pdf; IOSCO Principles for Financial Benchmarks: Final Report (July 2013), available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>; and Statement on Communication and Outreach to Inform Relevant Stakeholders Regarding Benchmarks Transition by the Board of the International Organization of Securities Commissions (IOSCO), July 31, 2019, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD636.pdf>.

⁸ *See, e.g.*, FSOC 2018 Annual Report, pages 4-5, 8-9, 108-109 (Dec. 19, 2018), available at: <https://home.treasury.gov/system/files/261/FSOC2018AnnualReport.pdf> ("The uncertainty surrounding LIBOR's sustainability may threaten individual financial institutions and the U.S. financial system more broadly. Specifically, without advance preparation, a sudden cessation of such a heavily used reference rate could cause considerable disruptions to, and uncertainties around, the large flows of LIBOR-related payments. It could also impair the functioning of a variety of markets, including business and consumer lending The Council recommends that member agencies work closely with market participants to identify and mitigate risks from potential dislocations during the transition process."); *see also* FSOC 2013 Annual Report, pages 6, 14-15, 137, 140-142 (June 2013) available at: <https://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf>.

⁹ Authorities representing United States banking regulators and other financial sector members, including the Commission, serve as non-voting *ex officio* members of the ARRC.

rates, identify best practices for contract robustness, develop an adoption plan, and create an implementation plan with metrics of success and a timeline.¹⁰

In June 2017, the ARRC identified a broad Treasuries repurchase agreement financing rate, SOFR, as the preferred alternative benchmark to USD LIBOR for certain new USD derivatives and other financial contracts.¹¹ The ARRC also published an updated Paced Transition Plan outlining the steps that the ARRC, derivatives clearing organizations, and other market participants intend to take in order to progressively build the liquidity required to support the issuance of, and transition to, contracts referencing SOFR.¹²

An essential piece of the ARRC's Paced Transition Plan is that DCOs, such as LCH, should cease to accept for clearing new contracts that use EFRR for discounting, and should instead use SOFR for that purpose.¹³ LCH is undertaking the discounting transition "in line with the Paced Transition Plan..."¹⁴

LCH intends to change the discounting rate used for the Affected Contracts¹⁵ from EFRR to SOFR at the end of the day on October 16, 2020. LCH states that "[t]he discounting transition for the Affected Contracts will result in a change in value and a discounting risk change. To mitigate the effects of these changes, LCH has designed a compensation process [that] is intended to avoid market disruption.... This compensation mechanism consists of two parts: value and risk compensation. For the risk compensation element, LCH will create and register [Discounting Swaps] in respect of clearing member and swaps customer positions which, to the extent practicable, will replicate the discounting risk for each account immediately following the [discounting] transition. These [Discounting Swaps] will be [EFRR]-SOFR basis swaps, achieved synthetically through a combination of [EFRR]-fixed and SOFR-fixed swaps, where the fixed legs are determined through a combination of the auction process... and LCH's end-of-day swaps valuation."¹⁶ The Discounting Swaps will be registered across the six Maturity Buckets, which will, to the extent practicable, replicate the discounting risk profile for each portfolio of Affected Contracts immediately following the discounting transition.¹⁷ Each Discounting Swap

¹⁰ In March 2018, the ARRC was reconstituted with expanded participation by additional financial institutions and trade organizations, and with additional government agencies added as *ex officio* members. Alternative Reference Rates Committee, Press Release, March 7, 2018, available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-March-7-2018-press-release.pdf>.

¹¹ See ARRC Press Release, June 22, 2017, available at <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf>.

¹² The ARRC's Paced Transition Plan for Developing SOFR Markets is available at: <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/paced-timeline-plan.pdf>.

¹³ *Id.*

¹⁴ LCH Letter at 1.

¹⁵ EFRR discounting is used at LCH for USD LIBOR, USD EFRR, and USD SOFR interest rate swaps, as well as USD CPI zero coupon inflation swaps. EFRR is also used in discounting for MXN swaps and non-deliverable swaps in 8 other currencies (KRW, CNY, INR, BRL, COP, CLP, THB, TWD). *Id.* at 1, n.2.

¹⁶ *Id.* at 1-2.

¹⁷ *Id.*

will be designed to have a zero net present value at the point of registration with a mid-price determined by the auction process.¹⁸

LCH asserts that, based on feedback from LCH clearing members and customers, “LCH offered swaps customers the ability to elect, via their clearing members, to have their Discounting Swaps liquidated through an auction process” to be carried out by LCH on the Auction Date.¹⁹ LCH also stated that “[a] further auction held on the Auction Date will provide the prices to be used by LCH to construct its SOFR zero coupon yield curve.”²⁰ For the purposes of liquidating the Elected Swaps, LCH will net all of the Elected Swaps for a specific Maturity Bucket into a single swap, which will be an Auction Swap.²¹

LCH states that, “[i]n order to ensure that the auction process is well-supported by clearing member bidders and that the associated pricing is competitive,” LCH has included in its rulebook a requirement that its sixteen largest clearing members participate in the auction and that two additional clearing members have also chosen to participate, for a total of eighteen expected auction bidders.²² In order to mitigate the risk of auction information being used for inappropriate purposes, the day before the Auction Date, LCH will also make the notional amount of the Auction Swaps public on its website.²³ On the Auction Date, the auction participants will submit one-way pricing to enter into the Auction Swaps (or a percentage range of the notional amount of the Auction Swaps) for a given Maturity Bucket.²⁴ The successful bidders will have the Auction Swaps (or a portion thereof), in the relevant Maturity Bucket, registered in their proprietary account after close of business on the Auction Date, once the terms of the Auction Swaps have become available through LCH’s end-of-day swaps valuation process, with LCH as their counterparty to a cleared swap contract.²⁵ The LCH customers that elect to have their Discounting Swaps liquidated through the auction will not become parties to any such swaps. Once cleared, LCH will report the Auction Swaps pursuant to Commission regulation 45.3(e), in accordance with LCH’s usual processes.²⁶

II. Request for Relief

LCH is requesting relief from certain real-time reporting requirements in Part 43 to permit delayed reporting of the swap transaction and pricing data related to the Auction Swaps, as required in Commission regulation 43.3, for four weeks from the Auction Date.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 3.

²⁶ *Id.*

LCH asserts that, due to the unique nature of the discounting transition and auction process, multiple clearing members have informed LCH that certain features of the Auction Swaps are not compatible with the clearing members' automated processes, including the processes related to reporting swap transaction and pricing data as required in Part 43 of the Commission's regulations. These clearing members do not believe they can satisfy the requirements of Commission regulation 43.3(a) to report the swap transaction and pricing data for the Auction Swaps as soon as technologically practicable after execution without significant expense to reprogram their reporting systems for a one-time event.²⁷ LCH states that it believes that LCH itself can perform the required Part 43 reporting on behalf of the clearing members under the provisions related to the reporting hierarchy in Commission regulation 43.3(a)(3),²⁸ but that LCH would need to manually repurpose the swap data that LCH will report pursuant to Commission regulation 45.3 to perform the reporting under Commission regulation 43.3(a), which would also prevent LCH from reporting the swap transaction and pricing data for the Auction Swaps within the required timeframe.²⁹

LCH also expressed concern that, absent the requested relief, these operational and reporting issues would discourage auction participants from submitting competitive bids in the auction process, which could harm the discounting transition process, creating risk management concerns for LCH as a DCO, and harm the overall transition from LIBOR to SOFR in the swaps marketplace.³⁰ LCH also expressed its belief that the impact of the requested relief on market transparency would be minimal, as LCH will publicly disclose information about the portfolio of Auction Swaps on the day prior to the auction.³¹

III. No-Action Relief

Based on the representations in the LCH Letter, DMO believes that time-limited no-action relief is warranted, and is providing such relief from certain real-time reporting obligations under Part 43 of the Commission's regulations in order to help facilitate a successful transition to SOFR discounting, which is an essential step to support the market adoption of SOFR on an accelerated basis and promote the further development of SOFR liquidity.

Pursuant to this relief, DMO will not recommend that the Commission take any enforcement action against LCH or any participants in the auction described in the LCH Letter for failure to comply with the real-time reporting requirements prescribed in Commission regulations 43.3(a)(1) and 43.3(a)(3) for the relevant Auction Swaps, provided that the following condition are met:

²⁷ *Id.* at 4.

²⁸ Section 43.3(a)(3) of the Commission's regulations allows the parties to a publicly reportable swap transaction to agree as to which party will report the swap transaction and pricing data for the swap prior to the execution of the swap. *See* 17 CFR 43.3(a)(3).

²⁹ *Id.* at 3.

³⁰ *Id.*

³¹ *Id.* at 2, 4.

1. The swap transaction and pricing data for each Auction Swap is reported to a swap data repository and publicly disseminated by that swap data repository no later than November 19, 2020; and
2. The relief granted in this letter applies only to the Auction Swaps executed on the Auction Date that result from the auction on that date described in the LCH Letter.

This letter, and the positions taken herein, represent the views of DMO only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the CEA or in Commission regulations. Further, this letter and the positions taken herein are based upon the facts and circumstances presented to DMO. Any different, changed, or omitted material facts or circumstances might render the relief provided by this letter void. Finally, as with all staff letters, DMO retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of relief provided herein, in its discretion.

If you have any questions concerning this correspondence, please contact Benjamin DeMaria, Special Counsel, at (202) 418-5988 or BDeMaria@CFTC.gov; or Roger Smith, Associate Chief Counsel, at (202) 418-5344 or RSmith@CFTC.gov.

Sincerely,

Dorothy D. DeWitt
Director