Commodity Futures Trading Commission
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CFTC's MRAC Subcommittee on Interest Rate Benchmark Reform Responses to Frequently Asked Questions (FAQs) on "SOFR First" for Non-Linear Derivatives[1]

What is the "SOFR First" recommendation for non-linear derivatives from the MRAC Subcommittee on Interest Rate Benchmark Reform ("MRAC Subcommittee")?

The MRAC Subcommittee believes that it is appropriate for interdealer brokers to change USD non-linear derivative trading conventions to SOFR on November 8, 2021, and for dealers to specify physical settlement for SOFR-based swaptions until a benchmark for SOFR swap rates is published in a tradeable form and ISDA publishes updated settlement provisions for the USD SOFR ICE Swap Rate.

How does "SOFR First" for non-linear derivatives relate to the previous "SOFR First" milestone date for linear derivatives?

The "SOFR First" Transition Initiative represents a prioritization of interdealer trading in the Secured Overnight Financing Rate (SOFR) rather than the London Interbank Offered Rate (LIBOR). The MRAC has recommended "SOFR First", inclusive of four distinct phases to occur sequentially: linear swaps (July 26, 2021), cross currency swaps (September 21, 2021), non-linear derivatives (November 8, 2021) and exchange-traded derivatives (TBD).

What products are considered USD non-linear derivatives?

For purposes of the "SOFR First" Transition Initiative, USD non-linear derivatives include swaptions, caps and floors. Other products like exotic options, Bermudan options and constant maturity swaps are not included in the MRAC Subcommittee's recommended "SOFR First" Transition Initiative, and may continue trading in the interdealer market after November 8, 2021.

Can end users still transact using USD LIBOR non-linear derivatives after November 8, 2021?

Yes, the "SOFR First" Transition Initiative is designed for the interdealer market only. Dealers may still execute USD LIBOR non-linear derivatives with clients after November 8, 2021. However, global banking regulators have stated that supervised entities should cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021.

[1] The "SOFR First" Transition Initiative was approved on July 13, 2021 by the Market Risk Advisory Committee (MRAC). The views, analyses, and conclusions expressed herein reflect the work of the Subcommittee on Interest Rate Benchmark Reform of the MRAC, and do not necessarily reflect the views of the Commodity Futures Trading Commission or its staff, or the U.S. government.

The “SOFR First” recommendation for linear swaps in July 2021 has been beneficial in removing liquidity impediments to transacting in SOFR linear swaps for end users, and the MRAC Subcommittee expects the “SOFR First” recommendation for non-linear derivatives to provide a similar benefit for end user activity in swaptions, caps and floors.

How can SOFR First for non-linear derivatives occur if there is not yet a tradeable benchmark for SOFR swap rates (for instance, the USD SOFR ICE Swap Rate), which may be important for valuing certain cash-settled non-linear products?

The MRAC Subcommittee recommends that dealers specify physical settlement for all interdealer swaption trades in connection with the SOFR First recommendation for non-linear derivatives. Swaptions that are physically settled do not create reliance on a benchmark for SOFR swap rates.

The MRAC Subcommittee understands from ICE Benchmark Administrator that a USD SOFR ICE Swap Rate benchmark is expected to become available in a tradeable form in the near term. The USD SOFR ICE Swap Rate is currently available in ‘beta’ form, and will be made tradeable by IBA once all necessary data validation and regulatory checks are completed.

Will the International Swaps and Derivatives Association (ISDA) update its Definitions for a SOFR Swap benchmark rate once available?

Yes, ISDA is in close coordination with ICE Benchmark Administrator to publish a Rate Option and updated settlement provisions for the USD SOFR ICE Swap Rate once available in a tradeable version.

Once the USD SOFR ICE Swap Rate is available in tradeable form, will the MRAC Subcommittee continue to recommend that interdealer swaption trades specify physical settlement?

No, once the ‘beta’ period for the USD SOFR ICE Swap Rate ends such that the rate is considered usable in transactions and ISDA publishes updated settlement provisions for the USD SOFR ICE Swap Rate, the MRAC Subcommittee encourages brokers and dealers to document SOFR-based swaption transactions however they deem most appropriate. The MRAC Subcommittee’s recommendation for physical settlement of SOFR-based swaptions is intended to remove any uncertainty around swaption expiries while the USD SOFR ICE Swap Rate is not yet available in a tradeable form.

What would be the potential outcome if a SOFR swaption were cash settled prior to IBA publishing the USD SOFR ICE Swap Rate in a tradeable form and ISDA publishing updated settlement provisions for the USD SOFR ICE Swap Rate?

A SOFR-based swaption may require cash settlement if such settlement is specified in a trade confirm, or if physical settlement is specified but a clearing fail occurs upon swaption expiry. To the extent market participants are required to cash settle such a swaption transaction documented without updated settlement provisions for the USD SOFR ICE Swap Rate, the determination of the cash settlement amount may be uncertain. Depending on the version of the settlement provisions incorporated into the swaption transaction, the calculation of such a cash settlement amount may rely on the USD LIBOR ICE Swap Rate, which would create unintended economic consequences.

After November 8, 2021, the recommended date for the transition of USD non-linear derivatives, will the MRAC Subcommittee focus on a similar "SOFR First" Transition Initiative for other products impacted by the transition away from LIBOR?

In the fourth quarter of 2021, the MRAC Subcommittee will communicate to the market its recommendation for a "SOFR First" Transition for exchange traded derivatives.