January 24, 2022

Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Swap Clearing Requirement To Account for the Transition From LIBOR and Other IBORs to Alternative Reference Rates

We appreciate the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its request for information regarding updating the swap clearing requirement to reflect interest rate benchmark reform.[1]

The clearing requirement is a central pillar of the post-crisis reforms to the OTC derivatives markets. In addition to mitigating systemic risk, central clearing increases market liquidity and transparency, improves investor protection, enhances competition, and reduces operational risk. As the global interest rate derivatives market transitions away from referencing interbank offered rates (such as USD LIBOR) to referencing new risk-free reference rates ("RFRs"), it is critical that the post-crisis reforms, including the clearing requirement, are applied to these new OTC derivative contracts.

The U.S. has been a global leader in implementing OTC derivatives clearing, and we encourage the Commission to expeditiously update the scope of the clearing requirement to reflect the significant amount of trading activity, and voluntary clearing, in OTC derivatives referencing SOFR and certain other RFRs. Doing so will ensure these markets develop as centrally-cleared markets, with the associated benefits of greater liquidity, transparency, and competition for market participants. Below, we provide several recommendations with respect to instrument scope and timing.

I. Instrument Scope

(a) RFRs

SOFR

As noted in the RFI, trading activity in OTC derivatives referencing SOFR has meaningfully increased in the latter half of 2021, sparked by the "SOFR First" initiative.[2] Current market liquidity, along with the voluntary clearing observed at DCOs, supports concluding that the relevant statutory factors are met in order to apply the clearing requirement to certain OTC derivatives referencing SOFR. We discuss each factor below:

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[1] Available at https://www.cftc.gov/sites/default/files/2021/11/2021-25450a.pdf (the "RFI").

[2] *See* https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam17#_ftn21.

- Outstanding notional exposures, trading liquidity, and pricing data. Market data shows robust trading liquidity in OTC derivatives referencing SOFR. The vast majority of trading activity in the interdealer segment of the market has now transitioned from referencing USD LIBOR to SOFR,[3] and client trading activity in SOFR swaps has significantly increased over the last few months, reflecting policymaker expectations.[4] In addition, streaming dealer prices can be observed across SEFs, evidencing the number of available market makers. Importantly, robust liquidity exists across a wide range of maturities, from 7 days to 50 years.

  Outstanding cleared notional has similarly increased, with more than $5 trillion in derivatives referencing SOFR now being cleared each month at LCH SwapClear.[5] As a result, DCOs have access to adequate pricing data in order to appropriately risk manage these instruments.

- Availability of a rule framework, capacity, operational expertise and resources, and credit support infrastructure. As noted above, OTC derivatives referencing SOFR are currently being cleared by DCOs in material volumes, demonstrating that the rule frameworks and operational infrastructure already exist to support a clearing requirement. Significant voluntary clearing demonstrates the confidence market participants have in the current DCO offerings.

- Effect on the mitigation of systemic risk. Applying a clearing requirement to OTC derivatives referencing SOFR will ensure these markets develop as centrally-cleared markets. As the Commission has previously noted,[6] central clearing provides greater systemic risk mitigation than bilateral margining for uncleared swaps. While bilateral margining may help reduce the market impact of a counterparty default, central clearing eliminates the complex web of interconnected bilateral counterparty credit exposures. These interconnected bilateral exposures are replaced not only with a margin framework applied by the DCO, but also centralized risk management and default management frameworks that are specifically designed to manage and mitigate the potential systemic impact of unexpected market events, including a counterparty default. In addition, DCOs facilitate multilateral netting and compression, increase efficiency with respect to collateral management and trade reconciliation, and provide market participants with increased transparency around end-of-day pricing.

- Effect on competition. Applying a clearing requirement to OTC derivatives referencing SOFR will increase liquidity and competition, thereby supporting the market's continued transition

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3 "SOFR Now 78% of Interdealer Market," Clarus Financial Technology (Oct. 19, 2021), available at: https://www.clarusft.com/sofr-now-78-of-interdealer-market/.

4 *See, e.g.,* "What Now for SOFR?" Clarus Financial Technology (Jan. 19, 2022), available at: https://www.clarusft.com/what-now-for-sofr/?utm_source=rss&utm_medium=rss&utm_campaign=what-now-for-sofr and Joint Statement on Managing the LIBOR Transition, Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, State Bank and Credit Union Regulators (Oct. 20, 2021), available at: https://www.federalreserve.gov/supervisionreg/srletters/SR2117a1.pdf.

5 *See* https://www.lch.com/services/swapclear/volumes/rfr-volumes.

6 *See, e.g.,* 81 Fed. Reg. 71202 (Oct. 14, 2016), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2016-23983a.pdf.

away from USD LIBOR. Central clearing enables market participants to access a wider range of execution counterparties and facilitates the entry of new liquidity providers. For instruments already subject to a clearing requirement, research confirms the benefits of increased liquidity and competition. A study of the index credit default swap market found that "the reduced counterparty risk and increased post-trade transparency associated with central clearing have beneficial effects on liquidity,"[7] while other research found that the Commission's clearing and trading reforms led to a significant reduction in execution costs in the USD interest rate swap market, with market participants saving as much as $20 million - $40 million per day.[8]

- Reasonable legal certainty in the event of insolvency. As with other instruments subject to a clearing requirement, the regulatory framework governing the treatment of customer and swap counterparty positions, funds, and property in the event of an insolvency is set forth in the U.S. Bankruptcy Code, the Commodity Exchange Act and Commission regulations and provides market participants with reasonable legal certainty.

It is important to note that voluntary clearing does not provide a substitute for applying a clearing requirement to OTC derivatives referencing SOFR. In particular, a clearing requirement has several important advantages compared to voluntary incentives, including (i) increasing the availability of client clearing offerings (as FCMs are encouraged to support the available DCO offerings), (ii) consolidating liquidity (which may be bifurcated between the cleared and uncleared versions of the instrument), and (iii) providing clients with confidence that there will be sufficient cleared liquidity to properly risk manage their positions. A clearing requirement is also a prerequisite for a SEF trading requirement to be extended to OTC derivatives referencing SOFR, which has been shown to deliver additional benefits to market participants in terms of liquidity, transparency, and competition.

Given the above, we recommend the Commission apply a clearing requirement to overnight index swaps referencing SOFR with a tenor of 7 days to 50 years.

Other RFRs

With respect to other RFRs, we recommend the Commission update the clearing requirement in a manner that seeks to maximize international harmonization.[9] In particular, OTC derivatives referencing SONIA and €STR have the necessary liquidity to support a clearing requirement.

Post-Trade Risk Reduction Services

The Commission should reject requests for additional exemptions, such as for post-trade risk reduction services, when updating the clearing requirement to include OTC derivatives referencing

[7] *See* Loon, Y. C., Zhong, Z. K. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. Journal of Financial Economics, 119 (3), 645–672 (2016) at page 4, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654.

[8] *See* Staff Working Paper No. 580 "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act", Bank of England (January 2016), available at: http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf.

[9] We note the recent actions by the Bank of England and ESMA to update clearing requirements for other RFRs.

RFRs. Existing no-action relief for multilateral portfolio compression exercises[10] has provided market participants with the necessary flexibility to reduce exposures in uncleared portfolios, while ensuring that swaps subject to the clearing requirement are actually cleared. A broader exemption that includes cleared swaps risks circumventing the clearing requirement, increasing trading activity in uncleared OTC derivatives, and increasing systemic risk.

(b) Swaps Subject to the Clearing Requirement

While we support updating the clearing requirement to include certain OTC derivatives referencing SOFR, it remains premature to remove the clearing requirement for OTC derivatives referencing USD LIBOR. This is because material volumes continue to be executed in USD LIBOR swaps that are currently subject to the clearing requirement, particularly in the dealer-to-customer segment of the market. In light of policymaker expectations, and continued growth in SOFR liquidity, we expect USD LIBOR swap liquidity to gradually decrease during 2022. However, in order to ensure continuity of clearing and trading workflows, we recommend that USD LIBOR swaps not be removed from the clearing requirement until trading activity has substantially decreased or DCO offerings are revised to no longer support the relevant USD LIBOR swaps.

II. Timing

Given current trading activity in OTC derivatives referencing SOFR and certain other RFRs, we recommend that the Commission update the clearing requirement as quickly as possible. This could include consideration of an interim final rule designed to reflect current market conditions.

Updates to the clearing requirement should be implemented at the same time for all market participants. This appropriately recognizes that a significant amount of voluntary clearing is already occurring and that all market participants currently subject to the clearing requirement should be well-prepared to clear OTC derivatives referencing RFRs as market liquidity continues to transition.

Finally, we note that an assessment of whether an instrument may potentially become subject to mandatory SEF trading in the future is not part of the criteria for determining whether OTC derivatives are suitable for the clearing requirement. However, under the made available to trade process, only a subset of instruments subject to mandatory clearing are also subject to mandatory SEF trading. Market experience has shown that those instruments currently subject to mandatory SEF trading are actively traded, highly liquid, and suitable for SEF trading.

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[10] CFTC Letter 13-01 (March 18, 2013), available at: https://www.cftc.gov/node/212491.

We appreciate the opportunity to provide comments to the Commission on the clearing requirement and interest rate benchmark reform. Please feel free to call the undersigned at (646) 403-8200 with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger
Managing Director
Global Head of Government & Regulatory Policy