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**Re: The Application of Uncleared Margin Requirements, Public Reporting, and Mandatory Clearing to OTC Derivatives Referencing SOFR**

We appreciate the opportunity to provide input to the Commodity Futures Trading Commission (the "Commission") as it continues to monitor the OTC derivative market's transition from referencing LIBOR (and other interbank offered rates) to referencing SOFR (and other new risk free reference rates). While we strongly support efforts by regulators to streamline a market-led transition, we caution against exempting new OTC derivatives referencing SOFR ("SOFR derivatives") from key pillars of the post-crisis financial reforms, such as uncleared margin requirements, public reporting, and mandatory clearing. Rather, we believe that the market for SOFR derivatives should be built on the solid foundation of these critical reforms in order to further secure and advance the objectives of mitigating systemic risk and increasing market stability, integrity, and efficiency. It is particularly noteworthy that volumes in the closely related SOFR futures market have been successfully growing *without* any regulatory exemptions with respect to margining, reporting, or clearing.

## I. New SOFR Derivatives Should Not Be Exempted from Uncleared Margin Requirements

While we support certain targeted and time-limited no-action relief, such as regulatory confirmation that amendments to legacy derivative contracts do not trigger the application of uncleared margin requirements if made solely to address interest rate benchmark reform,[1] we caution against providing a blanket exemption from uncleared initial margin requirements for new SOFR derivatives (even if it is time-limited) [2] for several reasons:

[1] *See* BCBS/IOSCO statement on the final implementation phases of the Margin requirements for non-centrally cleared derivatives (March 5, 2019), available at: https://www.bis.org/press/p190305a.htm.

[2] *See* "Treatment of Swaps Amended or Otherwise Transitioned from IBOR to Alternative Risk Free Rates under the Commodity Exchange Act" (Nov. 5, 2019), available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_CFTC_Relief_Request.pdf ("The ARRC requests that DSIO [. . .] grant no-action relief from the uncleared swap margin requirements for New SOFR Swaps that are not subject to mandatory clearing and that are executed before the date on which LIBOR will cease").

- **Compromises Systemic Risk Mitigation**. The financial crisis exposed the OTC derivatives markets as significantly under-collateralized. As a result, margin requirements for uncleared OTC derivatives represent a central pillar of the post-crisis reforms, designed to prevent the accumulation of under-collateralized bilateral exposures that can serve as a source of contagion and transmit risk in the event of a significant counterparty default. Providing a blanket exemption from uncleared initial margin requirements for new SOFR derivatives would permit certain OTC derivatives to once again be under-collateralized. As trading activity in SOFR derivatives increases, the size of these under-collateralized bilateral exposures may prove to be a source of systemic risk, undermining the post-crisis reform framework.

- **Disincentivizes Central Clearing**. The post-crisis reforms to the OTC derivatives market also seek to transition all standardized OTC derivatives into central clearing.[3] Uncleared margin requirements are important in this transition by establishing a level playing field between the cleared and uncleared markets with respect to collateralization practices, and thus removing a disincentive to centrally clear.[4] Providing a blanket exemption from uncleared initial margin requirements for new SOFR derivatives would disincentivize central clearing of these standardized derivatives. Data shows that bilateral trading is less costly than central clearing if there is an available exemption from the uncleared initial margin requirements, since initial margin would then only be required for cleared trades.[5] Among other anomalies, this would enable liquidity providers to quote better prices for uncleared SOFR derivatives than for cleared SOFR derivatives.

- **Bifurcates Liquidity**. Efforts solely focused on increasing trading activity and liquidity in uncleared SOFR derivatives risk negatively impacting overall market conditions by bifurcating liquidity between the cleared and uncleared version of the instrument. Given the transition of most all standardized interest rate derivatives to central clearing,[6] there is a general aspiration that liquidity in SOFR derivatives will naturally coalesce around the cleared version of the instrument.[7] However, a blanket exemption from uncleared initial margin requirements for new SOFR derivatives would provide a significant incentive to trade uncleared SOFR derivatives, increasing the likelihood that overall

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[3] *See* "G20 Leaders Statement: The Pittsburgh Summit," Sept. 25, 2009, available at: http://www.g20.utoronto.ca/2009/2009communique0925.html.

[4] *See* BCBS-IOSCO Margin requirements for non-centrally cleared derivatives (March 2015), available at: https://www.bis.org/bcbs/publ/d317.pdf.

[5] *See* Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (Nov. 19, 2018) at pages 36-37, available at: http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf (the "**DAT Report**").

[6] *See* "Remarks of CFTC Chairman J. Christopher Giancarlo at the Futures Industry Association Law & Compliance Division Conference" (May 10, 2019), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo72.

[7] *See, e.g.*, Transcript of the MRAC Meeting on July 12, 2018 at pages 181-82, available at: https://www.cftc.gov/sites/default/files/2018-12/mrac_071218_transcript.pdf.

market liquidity would be bifurcated between cleared and uncleared markets, to the detriment of participants in both markets.

- **Creates Additional Implementation Challenges**. Providing a blanket exemption for new SOFR derivatives would further increase the complexity associated with the phase-in of uncleared initial margin requirements. A multi-year phase-in of these requirements by participant type remains in progress, with an expected completion date of September 2021. Layering on additional phase-ins by product type would only increase the associated operational challenges for market participants. In addition, absent coordinated action from regulators in non-U.S. jurisdictions, a blanket exemption for new SOFR derivatives risks introducing additional cross-border complexity to the phase-in of uncleared initial margin requirements.

  Furthermore, providing an exemption from uncleared initial margin requirements for new SOFR derivatives may create challenges for market participants who nonetheless continue to post initial margin for these SOFR derivatives (despite the regulatory exemption) and wish to portfolio margin these positions with other interest rate derivatives that remain subject to the uncleared initial margin requirements. Further regulatory clarification would be needed to ensure that market participants could voluntarily include out-of-scope products for purposes of regulatory initial margin calculations.

## II. New SOFR Derivatives Should Not Be Exempted from Public Reporting Requirements

We also caution against providing any exemption from public reporting requirements for new SOFR derivatives. Academic research has found that the introduction of real-time public reporting in the OTC derivatives market has led to meaningful benefits for end investors, removing information asymmetries and facilitating more accurate assessments of execution quality.[8] By enabling investors to compare the prices they receive from liquidity providers with concurrent trading activity across the market, public reporting enhances investor confidence and incentivizes price competition as investors are able to demand more accountability from their liquidity providers. Furthermore, investors' understanding of, and confidence in, the emerging SOFR derivatives markets is predicated upon publicly available information about pricing and trading activity, as well as attendant research and analysis.[9] Ensuring that new SOFR derivatives benefit from the Commission's post-trade transparency framework will support the market's transition away from LIBOR, and help foster – not hinder – liquidity formation.

[8] *See, e.g.,* Loon, Y. C., Zhong, Z. K., 2014. The impact of central clearing on counterparty risk, liquidity, and trading: Evidence from the credit default swap market. Journal of Financial Economics, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176561; Loon, Y. C., Zhong, Z. K., 2015. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports, Journal of Financial Economics, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654.

[9] *See, e.g.,* "SOFR Market Developments" from Clarus Financial Technology, available at https://www.clarusft.com/sofr-market-developments/.

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## III. A Forward-Looking Plan Should Be Developed to Bring SOFR Derivatives Under the Clearing Mandate

As trading activity in cleared SOFR derivatives increases, we recommend that the Commission support this transition by developing and communicating a forward-looking plan to apply the clearing mandate to these instruments. Research has found that central clearing has a positive impact on market liquidity.[10] In addition, a clearing mandate has several important advantages compared to voluntary incentives, including (a) increasing the availability of client clearing offerings,[11] (b) consolidating liquidity (which may be bifurcated between the cleared and uncleared versions of the instrument), and (c) providing clients with confidence that there will be sufficient cleared liquidity to properly risk manage their positions.

With more than $100 billion of SOFR derivatives already cleared,[12] we recommend that the Commission regularly re-assess market conditions pursuant to its existing framework for making clearing requirement determinations.[13] Ensuring that the SOFR derivatives market matures as a cleared market will mitigate systemic risk, increase market transparency, and improve liquidity conditions for all market participants.

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We appreciate the opportunity to provide comments on 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

CC: Dr. Heath P. Tarbert, Chairman
Mr. Brian D. Quintenz, Commissioner
Mr. Rostin Behnam, Commissioner
Ms. Dawn DeBerry Stump, Commissioner
Mr. Dan M. Berkovitz, Commissioner

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[10] *See* Loon, Y. C., Zhong, Z. K. 2015. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports, Journal of Financial Economics at page 4, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654 ("the reduced counterparty risk and increased post-trade transparency associated with central clearing have beneficial effects on liquidity").

[11] *See* DAT Report at page 23.

[12] "Libor leaders: LCH brings SOFR swaps into the fold," Risk.net (June 19, 2019), available at: https://www.risk.net/derivatives/6707761/libor-leaders-lch-brings-sofr-swaps-into-the-fold.

[13] 77 Fed. Reg. 74284.