September 4, 2020

Treasury and IRS colleagues,

As discussed, we are submitting a request for guidance concerning the market's transition to SOFR discounting with respect to a vast number of existing financial contracts that currently use the effective federal funds rate ("EFFR") as the discount rate (the "Discounting Transition"), as described further below. The Discounting Transition for cleared derivatives is a key step in the overall transition from LIBOR to SOFR, but because the transition involves a shift from EFFR, instead of an interbank offered rate (an "IBOR"), Proposed Treasury Regulations section 1.1001-6 (the "Proposed Regulations") does not apply to it. In order to fill this gap in guidance, the ARRC recommends that the final version of the Proposed Regulations apply to the Discounting Transition by treating EFFR as an IBOR for this limited purpose.

Since 2016, in connection with its work to identify a replacement rate for LIBOR, the ARRC has envisioned that the replacement rate it identified would ultimately take the place of EFFR as the discounting and time value compensation rate used in connection with certain cleared derivative products as a way of building demand and liquidity in the derivatives market for the proposed replacement rate.[1] The Discounting Transition for existing cleared derivatives, and the requirement to use SOFR for discounting on all new cleared derivative contracts entered into after October 16, 2020, is the critical fourth step in the current version of the ARRC's Paced Transition Plan that is designed to encourage the adoption of SOFR in preparation for the transition away from LIBOR.[2]

By significantly increasing market participants' exposure to SOFR, the Discounting Transition is expected to increase the volume of derivative products referencing SOFR as well as its overall liquidity.[3] A more liquid market in SOFR products will reduce market disruption in connection with the transition from LIBOR to SOFR.[4] Thus, the Discounting Transition, as applied to cleared derivatives, is an integral component of the ARRC's planning to facilitate the transition away from LIBOR. Expanding guidance to cover the Discounting Transition is, therefore, in keeping with the policies of reducing uncertainty and minimizing taxpayer burden on the LIBOR transition that underlie the Proposed Regulations, while helping to facilitate an orderly market transition.

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[1] See ARRC, Interim Report and Consultation, May 2016, https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2016/arrc-interim-report-and-consultation.pdf ("Because both of the potential alternatives preliminarily identified by the ARRC are overnight rates, the need to build an initial level of demand and liquidity in derivatives markets based on either rate will necessarily involve transitioning some current private sector uses of the EFFR, the current overnight index used by market participants, to the new overnight interest rate benchmark (new rate) that the ARRC will eventually propose. Therefore, the ARRC has mapped out a potential initial strategy for moving PAI and discounting . . . to the new rate.").

[2] The ARRC's Paced Transition Plan for Developing SOFR Markets, NEWYORKFED.ORG (Jun. 12, 2020), https://www.newyorkfed.org/medialibrary/microsites/arrc/files/paced-timeline-plan.pdf.

[3] Market participants using cleared derivative products often hedge their exposure to the discounting rate, which, in turn, generates demand for derivative products referencing the relevant discounting rate.

[4] *See Letter to All SwapClear Users re: Proposed Next Steps for Transition to USD SOFR Discounting in SwapClear* Section 7 (Jul. 26, 2019), https://www.cftc.gov/media/3221/MRAC_LCH_SOFRDiscountingLetter121119/download ("The conversion to SOFR discounting is a crucial step in realizing [interest rate benchmark reform in the USD market].").

U.S. Dollar derivatives[5] cleared by CME Group and LCH (together, the central counterparties, or "CCPs") will undergo the Discounting Transition after the close of business on October 16, 2020.[6] At that time, SOFR will replace EFFR as the rate used by the CCPs (i) to calculate the present value of future cash flows on derivatives between a CCP and its counterparty for purposes of measuring collateral requirements for the impacted derivatives and (ii) to determine the time value compensation paid by a CCP or its counterparty on collateral with respect to those cleared derivatives.[7] The Discounting Transition will result in a counterparty's cleared derivatives having an immediately higher or lower value due to the change in the discount rate used by the CCPs to value these contracts, which will trigger an equal change in the related collateral requirements. "To neutralize the value transfer from the change to SOFR discounting, [the CCP] will process a cash adjustment that is equal and opposite to the [net present value] change on each trade in all accounts."[8] Thus, the CCPs will make a payment to, or receive a payment from, each party to a derivative (a "cash adjustment") to offset the change in value resulting from the change in discount rate. The cash adjustment will also exactly offset the receipt of, or requirement to post, additional collateral. In addition, the Discounting Transition will result in a change in a counterparty's risk profile from EFFR to SOFR going forward. To compensate for this, the CCP will book a set of "basis swaps," structured to have a net present value of zero at the time of issuance, on each participant's account.[9] The basis swaps and the cash adjustment together are designed to return

[5] The Discounting Transition will apply to a variety of cleared derivatives, such as interest rate swaps, overnight index swaps, forward rate agreements, basis swaps, zero coupon swaps and swaptions.

[6] For general background see LCH and Benchmark Reform, https://www.lch.com/Services/swapclear/benchmark-reform (last visited Sept. 3, 2020) and *€STR and SOFR Discounting Transitions for Cleared Swaps, CME Group*, (May 28, 2020), https://www.cmegroup.com/education/articles-and-reports/estr-and-sofr-discounting-transitions-for-cleared-swaps.html.

[7] This amount may be referred to as "price alignment interest" (PAI), "price alignment amount" (PAA), or simply "price alignment" (PA).

[8] *SOFR Discounting Transition – Process for Cleared Swaps, CME Group* p.2, CMEGROUP.COM (Aug. 2020), https://www.cmegroup.com/trading/interest-rates/files/discounting-transition-proposal-aug-2020.pdf. *See also LCH's Transition from Fed Funds to SOFR Discounting in its SwapClear Service,* LCH.COM (Jun. 18, 2020), https://www.lch.com/risk-management/risk-management-ltd/ltd-risk-notices/lchs-transition-fed-funds-sofr-discounting-its (to address "the gains and losses from the [rate] switch," LCH will "provide a compensation process designed to minimize the impact of these changes on [its] users"). For LCH, this payment is effected by booking a "swap" that settles on October 20, 2020. *See Transition to €STR and SOFR discounting in SwapClear*, p.6, LCH.COM, https://lch.com/sites/default/files/media/files/Transition%20to%20EuroSTR%20and%20SOFR%20Discounting%20in%20SwapClear%20Feb%202020%20FINAL.pdf.

[9] Participants who do not wish to receive these basis swaps can elect to have the basis swaps they would otherwise be entitled to receive be sold in an auction held by the CCP shortly after the Discounting Transition on Monday, October 19, 2020. The electing participants will be required to make, or will receive, a payment with respect to the basis swaps they otherwise would have received based on the results of the auction. *See SOFR Discounting Transition – Process for Cleared Swaps, CME Group* p.2, CMEGROUP.COM (Aug. 2020), https://www.cmegroup.com/trading/interest-rates/files/discounting-transition-proposal-aug-2020.pdf ("CME will facilitate an auction for participants looking for an efficient way to unwind their basis swaps") and *Letter to All SwapClear Users re: Proposed Next Steps for Transition to USD SOFR Discounting in SwapClear* Section 7 (Jul. 26, 2019), https://www.cftc.gov/media/3221/MRAC_LCH_SOFRDiscountingLetter121119/download ("LCH intends to run a centralized auction in order to . . . establish the market value of [the swaps] (which determines the amount of cash payable)").

each party to a cleared derivative to approximately the same position they were in before the discount rate was replaced.[10]

The ARRC expects that many non-cleared cash collateralized financial contracts that currently use EFFR discounting will also be modified to use SOFR discounting for purposes of measuring collateral requirements and SOFR as the rate used to calculate the time value compensation on the associated collateral, though the bilateral negotiations required for these amendments will likely occur over a period of time. For a market participant, applying the Discounting Transition to collateral arrangements of over-the-counter contracts as well as cleared contracts will ensure that a single discounting rate applies to the market participant's entire book of derivatives, thereby facilitating hedging and reducing risk. As in the case of cleared contracts, parties that amend a contract to provide for SOFR discounting in lieu of EFFR discounting may negotiate a cash adjustment to compensate for the change in value resulting from the amendment. In addition, in connection with the Discounting Transition with respect to such collateral arrangements, many financial institutions and other market participants are expected to transition from EFFR to SOFR as the discounting rate used for financial contracts for purposes of mark-to-market valuations required under GAAP and Section 475 of the Internal Revenue Code.

Expanding the scope of the anticipated final regulations to treat EFFR as an IBOR solely in connection with the Discounting Transition, or issuing separate non-regulatory guidance to that effect, would be a tailored, limited expansion of the current scope of the Proposed Regulations to provide taxpayers with greater clarity regarding an important piece of the overall plan to transition the market to SOFR. For example, this guidance would confirm for market participants that the Discounting Transition would not result in a taxable exchange of any financial contract that was affected by a discounting rate change. It would also provide guidance with respect to the treatment of the cash adjustments by reference to the rules in the Proposed Regulations for one-time payments. Finally, if the final regulations provide guidance with respect to Section 475, as previously recommended by the ARRC, it would provide guidance to those taxpayers that change the discounting rate they use to value financial contracts for financial accounting and reporting purposes under GAAP and for tax purposes.

The ARRC therefore requests that guidance provided in the Proposed Regulations be expanded to include the replacement of EFFR by SOFR in connection with the Discounting Transition. The ARRC would be happy to discuss this issue further, including regarding timing and procedural matters related to the requested guidance, or answer any questions you may have.

[10] "To mitigate these changes LCH has designed a compensation process which avoids unnecessary disruption, is as simple and straightforward as possible yet operates to a high level of accuracy, aims to provide coverage of risk mitigation where needed, with the flexibility to opt out of certain components if required." *LCH's Transition from Fed Funds to SOFR Discounting in its SwapClear Service,* LCH.COM (Jun. 18, 2020), https://www.lch.com/risk-management/risk-management-ltd/ltd-risk-notices/lchs-transition-fed-funds-sofr-discounting-its.