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December 9, 2019

Re: Guidance Relating to the ISDA Protocol Regarding the Incorporation of Robust Fallback Provisions to IBOR Reference Rates

Ladies and Gentlemen:

The Alternative Reference Rates Committee (the "ARRC"), a committee convened by the Board of Governors of the Federal Reserve and by the Federal Reserve Bank of New York with the support of a number of agencies including the U.S. Department of the Treasury ("Treasury"), is writing to request standalone guidance relating to one or more Interbank Offered Rate ("IBOR") fallback-related protocols to be published by the International Swaps and Derivatives Association ("ISDA") early next year (the "Protocol").

The ARRC greatly appreciates the Guidance on the Transition from Interbank Offered Rates ("IBORs") to Other Reference Rates, published in the Federal Register on October 9, 2019 (the "Proposed Regulations"), and the work done by Treasury and the Internal Revenue Service (the "IRS") to address tax issues arising from the IBOR transition, including issues raised by the ARRC in its prior comments dated April 8, 2019[1] and June 6, 2019.[2] However, as discussed in further detail below, it is not clear whether adherence to the Protocol or adoption of comparable fallback provisions by parties to a contract will qualify for the relief provided in the Proposed Regulations. Due to the time-sensitive nature of this issue, the ARRC is providing its initial comments with respect to the Protocol in this letter and will separately provide additional comments regarding the Proposed Regulations.

Currently, derivative contracts that are based on ISDA documentation contain fallback provisions that are widely considered by both private-sector participants and the official sector to be highly likely to lead to widespread disruptions in the event of a permanent discontinuation of the relevant IBORs. The Protocol is intended to address this issue by providing a mechanism for parties to remediate their existing contracts, which are massive in number,[3] without the need for individual negotiations. Broad market adherence to the Protocol will help to ensure that market participants are protected from the disruption that could occur under the current fallbacks included in ISDA documentation. On the other hand, uncertainty about the tax consequences of adhering to the Protocol could cause market participants to delay adhering to the Protocol or making contractual modifications to implement comparable fallback provisions. Accordingly, the ARRC requests in this letter that Treasury and the IRS issue interim guidance specifically addressing the Protocol.

This letter provides background regarding the mechanics of over-the-counter ("OTC") derivative contracts based on the standardized documentation published by ISDA, the Protocol and the need for additional guidance. In addition, it provides a description of the guidance that the ARRC recommends to address the concerns raised by the Protocol, including proposed language for such guidance.

I. Background Regarding the Protocol

a. General Background on ISDA Master Agreements and Protocols

ISDA publishes documents, including "Master Agreements" and "Definitions," which are used to provide standardized terms that form the basic framework of most OTC derivative contracts. Individual trades under an ISDA Master Agreement are generally documented by way of a "confirmation," which details the terms of the specific transaction and incorporates relevant ISDA Definitions, including the 2006 ISDA Definitions (the "Definitions") for interest rate derivative contracts. This general framework enables market participants to streamline their negotiations by relying on industry-standard terms, and ensures greater consistency across the derivatives market. This consistency, in turn, reduces risk for market participants.

A protocol is a mechanism to effect a multilateral amendment to existing ISDA-based contracts. Protocols provide an efficient way of implementing standard contractual changes among a large group of parties; in doing so, they enable parties to avoid time-consuming and costly bilateral negotiations. A

[1] *See* the ARRC's whitepaper on U.S. federal income tax issues relating to the transition from IBORs to RFRs, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Tax-Whitepaper-April2019.pdf.

[2] *See* the ARRC's proposed language for guidance relating to certain tax issues submitted to Treasury relating to the Transition from IBORs to RFRs, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Proposed_Transition_Guidance.pdf.

[3] As of the end of 2016, there was approximately $145 trillion notional amount of outstanding over-the-counter derivatives. *See* the second report by the ARRC, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

market participant who wishes to "adhere" to a protocol submits an "adherence letter" to ISDA, which publishes the names of the adhering parties on its website.[4] If two parties to an ISDA-based contract adhere to a protocol, all of the contracts that they have outstanding with each other will be legally modified in accordance with the terms provided by the relevant protocol as of the date that the last of the parties adhered to the protocol (or as of a later date set out in the protocol). The adherence typically applies to all outstanding ISDA Master Agreements, and associated confirmations, to which the relevant market participant is a party, provided that the other party has also adhered.

b. The Protocol – Process

The current version of "Rate Options" for IBORs in the Definitions does not incorporate robust "fallback" provisions that would provide clarity, certainty and consistency regarding the appropriate replacement rate once an IBOR has been permanently discontinued. At the request of the Financial Stability Board's (the "FSB's") Official Sector Steering Group,[5] ISDA has been leading an industry effort to implement robust fallback language for derivatives contracts since 2016.[6]

ISDA has announced that it will amend the Definitions to provide for fallback reference rates in the Rate Options for LIBOR and certain other IBORs to address the circumstances under which those IBORs cease to exist, or possibly cease to be representative, at some point in the future (such provisions, the "ISDA fallback provisions," and such amended Definitions, the "Amended Definitions").[7] The ISDA fallback provisions will contain terms to establish the base replacement risk-free rate ("RFR") for each IBOR (any such base replacement rate, a "new fallback rate") as well as a spread adjustment that will apply (the "spread adjustment").

Simultaneously with the publication of the Amended Definitions, ISDA will publish the Protocol to facilitate multilateral amendments to incorporate the Amended Definitions into outstanding OTC derivative contracts (so-called "legacy derivative contracts"). By adhering to the Protocol, market participants will agree that any legacy derivative contracts with a counterparty who also adheres will be modified to reference the Amended Definitions, including the ISDA fallback provisions. As an alternative to adhering to the Protocol, a party can seek to enter into a bilateral agreement with a derivative counterparty to amend its legacy derivative contracts with that counterparty to include the Amended Definitions, as discussed below.

To determine the methodologies to be included in the ISDA fallback provisions, and at the request of international regulators, ISDA has conducted global, market-wide consultations on various technical issues.[8] In an October 2019 letter to the Antitrust Division of the U.S. Department of Justice,

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[4] The Protocol webpage contains information on the various open and closed protocols, including lists of the adhering parties. *See* https://www.isda.org/protocols/.

[5] Letter from FSB Co-Chairs to ISDA, July 7, 2016, attached as Appendix C to FSB Progress Report on Implementation of July 2014 FSB Recommendations, October 10, 2017, *available at* https://www.fsb.org/wp-content/uploads/P101017.pdf. The FSB Progress Report identifies the issues that may arise in a transition to reformed or new proposed interest rate benchmarks and makes recommendations to regulators and market participants (e.g., market associations such as ISDA) for addressing them.

[6] *See* ISDA Consultation from July 2018, p.3, *available at* http://assets.isda.org/media/f253b540-193/42c13663-pdf/.

[7] *See* the ISDA consultation on final parameters for fallback adjustments, *available at* https://www.isda.org/a/Ua0TE/Consultation-on-Parameters-for-Fallback-Adjustments.pdf.

[8] The consultations are available at the following web addresses:

ISDA affirmed that it made substantial efforts to ensure that the consultations were fair, transparent and objective.[9] For example, questions were designed to elicit narrative feedback and to avoid limiting or steering responses. To provide procedural safeguards, ISDA engaged antitrust counsel and third-party consultants to assess responses and ensure that information was shared appropriately. The consultations garnered a large number of responses from market participants representing several business sectors and countries. The consultants engaged by ISDA have released reports discussing the responses received and their conclusions based on those responses.[10]

ISDA expects to publish the Amended Definitions and Protocol by February 2020 for all IBORs. This publication will mark the beginning of a three-month period during which market participants will have the opportunity to adhere to the Protocol prior to a specific date on which the amendments to the Definitions will take effect (the "Initial Adherence Period"). After the end of the Initial Adherence Period, all new Definitions-based derivative transactions will reference the Amended Definitions, as will all legacy derivative contracts modified pursuant to the Protocol or through bilateral amendments incorporating the Amended Definitions. The occurrence of these changes on the same date should increase market consistency and predictability. LCH and CME have also announced that they will implement rule changes implementing revised fallback language in all derivative contracts they clear, including outstanding derivative contracts, on the date the Amended Definitions take effect.[11]

Broad adherence to the Protocol during the Initial Adherence Period is of critical importance to the wider goal of ensuring that market participants are protected from widespread disruptions in the event of a permanent discontinuation of the relevant IBORs. John C. Williams, president and Chief Executive Officer of the Federal Reserve Bank of New York, recently stated:[12]

> Derivatives contracts account for 95 percent of the exposure to U.S. dollar LIBOR, so universal changes to these contracts would be a significant leap forward. If the market

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http://assets.isda.org/media/f253b540-193/42c13663-pdf/,
https://www.isda.org/a/md6ME/FINAL-Pre-cessation-issues-Consultation.pdf,
https://www.isda.org/a/n6tME/Supplemental-Consultation-on-USD-LIBOR-CDOR-HIBOR-and-SOR.pdf,
and
https://www.isda.org/a/Ua0TE/Consultation-on-Parameters-for-Fallback-Adjustments.pdf.

[9] *See* the supplemental letter submitted by ISDA on October 23, 2019 to the Antitrust Division of the U.S. Department of Justice, attached hereto as Appendix C. The original letter submitted by ISDA on June 4, 2019 is attached hereto as Appendix D.

[10] The reports are available at the following web addresses:
http://assets.isda.org/media/04d213b6/db0b0fd7-pdf/,
http://assets.isda.org/media/e0b1bac2/04397355-pdf/,
https://www.isda.org/a/0LPTE/2019.09.18-Anonymized-ISDA-Supplemental-Consultation-Report.pdf, and
http://assets.isda.org/media/3e16cdd2/d1b3283f-pdf/.

[11] The stated intentions of CME and LCH are available publicly at https://www.cmegroup.com/education/articles-and-reports/cme-group-supports-isda-s-libor-fallback-provisions.html and https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-position-respect-isdas-recommended-benchmark. The ARRC believes that such revisions will not result in "modifications" of the relevant cleared derivative contracts for purposes of Section 1001 of the Internal Revenue Code (the "Code") because, pursuant to the terms of the rules governing the cleared derivative contracts to be revised, LCH and CME have the authority to make such changes unilaterally.

[12] John C. Williams, Remarks at the 2019 U.S. Treasury Market Conference, Federal Reserve Bank of New York, New York City, September 23, 2019, *available at* https://www.newyorkfed.org/newsevents/speeches/2019/wil190923.

> signs up to the Protocol when it's published, it will be a considerable milestone and will go a long way toward reducing risks to firms, markets, and the financial system. . . .

In a similar vein, Randal K. Quarles, vice chair for supervision of the Federal Reserve Board of Governors, recently stated that "it will be crucial in ensuring global financial stability that everyone participate in the International Swaps and Derivatives Association's (ISDA) consultations on better fallback language for LIBOR derivatives and then sign the Protocol so that these fallback provisions apply to the legacy book of derivatives."[13]

Broad participation during the Initial Adherence Period would signal strong market support for the Protocol and thereby encourage other market participants to adhere to the Protocol as well. Wide uptake of the Protocol will reduce market risk in that parties will be less exposed to varying and unpredictable outcomes that could arise if some of a party's legacy derivative contracts contain the new and more robust ISDA fallback provisions while others do not. This was acknowledged in a letter to ISDA dated March 12, 2019, by the Co-Chairs of the FSB, where they stated that:

> The measures that ISDA is taking will play a very important role in the transition from LIBOR and will serve to strengthen contract language in derivatives referencing other IBORs. The adoption of appropriately revised fallbacks by market participants will help to mitigate a key source of risk to the financial system.

On November 7, 2019, the Federal Reserve Board, the FDIC, the OCC, and other agencies released a proposal on adjusting margin requirements for covered swap entities that, among other things, is meant to remove unintended hurdles to adhering to the Protocol and moving away from LIBOR.[14] Additionally, the Financial Accounting Standards Board (the "FASB") has issued an exposure draft with proposals that would ease the transition from legacy IBORs to RFRs from an accounting perspective[15] and recently affirmed its proposals, with the goal of finalizing the guidance in early 2020.[16]

While not all terms of the ISDA fallback provisions are finalized, most material terms have been determined, based on the final consultation results published by ISDA on November 15, 2019.[17] The specific terms of the anticipated ISDA fallback provisions are discussed below.

c. <u>Methodology in the ISDA Fallback Provisions</u>

In the Amended Definitions, ISDA intends to amend the Rate Options to provide that an announcement or publication regarding the permanent discontinuation of an IBOR triggers the ISDA

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[13] Randal K. Quarles, Speech at the Alternative Reference Rates Committee Roundtable, June 3, 2019, *available at* https://www.federalreserve.gov/newsevents/speech/quarles20190603a.htm.
[14] The proposal is available at https://www.fdic.gov/news/board/2019/2019-09-17-notice-dis-b-fr.pdf.
[15] The FASB guidance is available at https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176173289025&acceptedDisclaimer=true.
[16] *See* the FASB News Release, November 13, 2019, *available at* https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176173736549&pagename=FASB%2FFASBContent_C%2FNewsPage.
[17] The full report on ISDA's consultation on final parameters for fallback adjustments is available at https://www.isda.org/a/Ua0TE/Consultation-on-Parameters-for-Fallback-Adjustments.pdf.

fallback provisions (a "trigger event").[18] ISDA has not yet determined if the amendment will also provide for a trigger event resulting from an announcement by a regulator that an IBOR is no longer representative (a "pre-cessation trigger").

Due to the differences between RFRs and IBORs, it will be necessary to adjust the spread above the applicable IBOR in a derivative contract with a higher spread above the applicable RFR. Accordingly, upon a trigger event a spread adjustment will be calculated to take effect when the discontinued IBOR is replaced with the new fallback rate, which in the case of U.S. dollar LIBOR will be the Secured Overnight Financing Rate ("SOFR"). The new fallback rate, together with the spread adjustment, will replace the IBOR as the reference rate under the terms of the contract once the IBOR is actually discontinued (such date, the "replacement date"). ISDA has announced that Bloomberg Index Services Limited ("Bloomberg") will produce and publish the new fallback rates and the spread adjustments, as well as an "all-in" rate including both, for each IBOR tenor upon the occurrence of the relevant trigger event.[19] Bloomberg will also publish indicative spread adjustments and resulting fallback rates prior to a trigger event.

To determine the spread adjustment accompanying the transition to the new fallback rate, ISDA anticipates the use of a five-year historical median approach whereby the median spread between the relevant IBOR and the relevant new fallback rate compounded over a period that corresponds to the applicable IBOR tenor (e.g., three months) are calculated over a five-year look-back period. In order to avoid distortions due to market disruption during the period between the trigger event and the replacement date, the relevant spread adjustment will be calculated based on the five-year look-back period ending on the business day prior to the trigger event. Attached as Appendix B is an illustration of a hypothetical timeline for the replacement of a relevant IBOR with a new fallback rate in an ISDA-based contract pursuant to the Amended Definitions (which could be incorporated into legacy derivative contracts through adherence to the Protocol or bilateral amendment) and subsequent operation of the ISDA fallback provisions.

There are several adjustments necessary to account for the fact that RFRs are overnight rates and IBORs are forward looking term rates. Under the ISDA fallback provisions, the rate for a payment period will be based on a "backward-looking" compounded setting in arrears rate whereby the relevant new fallback rate is observed over a period of time that is generally equivalent to the relevant IBOR tenor and compounded daily during that period. To deal with the operational difficulty of making a payment on a derivative contract based on a rate that is only known at the end of the period as opposed to the forward looking IBOR rates historically used, it is anticipated that the observation period for determining payments under a derivative contract referencing the new fallback rate will be shifted back by two days. This would mean that the last observation of the new fallback rate for any calculation period would generally be two banking days before the relevant payment date.[20]

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[18] For further information on the fallback triggers for a permanent cessation of an IBOR, see pages 5 – 6 of the July 2018 ISDA Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW, *available at* http://assets.isda.org/media/f253b540-193/42c13663-pdf/.
[19] The ISDA announcement is available at https://www.isda.org/2019/07/31/bloomberg-selected-as-fallback-adjustment-vendor/.
[20] Laying out the material terms of the anticipated ISDA fallback provisions, the report on ISDA's latest consultation stated the following conclusions:

- Using the feedback collected from respondents, ISDA expects to implement a historical median spread adjustment over a five-year lookback period without including a transitional period, without excluding

As noted above, a few minor details of the ISDA fallback provisions remain unresolved. Most unresolved terms relate to minor calculation mechanics—for example, incorporating holiday calendars for compounding. ISDA also continues to consider the inclusion of pre-cessation trigger events in the Protocol.[21] Additionally, ISDA has yet to consult on the methodologies for adjustments to the Definitions in respect of EURIBOR and EUR LIBOR, but expects to do so by mid-December.[22] It is possible that the Amended Definitions used by the Protocol will include ISDA fallback provisions for such rates.

d. Bilateral Amendments

It is expected that some market participants will incorporate the ISDA fallback provisions for IBORs through bilateral agreements rather than adherence to the Protocol. Parties may choose to enter into bilateral agreements for a variety of reasons, including to amend contracts with a non-adhering counterparty, to amend contracts that are not based on an ISDA Master Agreement, based on general practice to effect amendments that could be made by protocols through bilateral agreements, due to governance difficulties in approving a protocol adherence or because of timing issues related to adherence.[23]

In many cases involving bilateral amendments, the expectation is that the parties will adopt fallback provisions identical to the ISDA fallback provisions included in the Amended Definitions (including the new fallback rates and spread adjustments that will be published by Bloomberg). However,

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outliers and without excluding negative spreads. The spread adjustment will be applied to a compounded in arrears rate with the applicable calendar to be determined and announced by Bloomberg prior to implementation. Respondents supported a two-Banking Day backward shift adjustment period, which is anticipated to apply absent fundamental conflict with the suitability and implementation of the adjusted fallback rates. ISDA also plans to continue its review of and discussing with market participants regarding the feedback it received regarding products that may not work using these approaches.

- Bloomberg and ISDA will publish the final and full mathematical formulas for the spread adjustment and compounded in arrears rate (with adjustment period) prior to publication by Bloomberg of the adjusted fallback rates and implementation of the fallbacks in the 2006 ISDA Definitions.

See page 34 of the report, *available at* http://assets.isda.org/media/3e16cdd2/d1b3283f-pdf/.

[21] If a pre-cessation trigger event were included in the Protocol, the ISDA fallback provisions would operate in a manner similar to what is currently contemplated, except that the trigger event might occur earlier than is currently contemplated. In an ISDA consultation focused on certain pre-cessation issues, a majority of respondents indicated they would be supportive of the inclusion of a pre-cessation trigger event. However, there remains disagreement regarding the implementation of such a trigger event. *See* pages 35 – 36 of the ISDA Consultation on Certain Pre-Cessation Issues, *available at* https://www.isda.org/a/md6ME/FINAL-Pre-cessation-issues-Consultation.pdf . The FSB has recently issued a letter to ISDA requesting that such trigger events be included in the Protocol. *See* Letter from FSB Co-Chairs to ISDA, November 15, 2019, *available at* https://www.fsb.org/wp-content/uploads/P191119.pdf. The ARRC believes the discussion herein is not impacted by the potential inclusion of a pre-cessation trigger event.

[22] Fallback provisions for EUR LIBOR and EURIBOR have followed a different timetable because the fallback rate, €STR, was only published on October 2, 2019.

[23] It is also possible that market participants who amend legacy derivative contracts will desire to amend concurrently the fallback provisions applicable to debt instruments hedged by such derivative contracts. The ability of market participants to rely on the guidance requested for these debt instruments, as well as other non-derivative contracts that use contractual language comparable to the ISDA fallback provisions, would remove uncertainty regarding the tax treatment of such amendments, which the ARRC expects would increase the number of market participants who adhere to the Protocol or adopt comparable contractual provisions.

there may be certain terms that the parties wish to include or amend. Some examples of terms which parties may wish to modify include the following:

- If the Amended Definitions do not include a pre-cessation trigger event, it is possible that parties will want to include one through bilateral amendment.
- Parties may wish to make revisions to the ISDA fallback provisions necessary to address certain administrative and technical issues applicable to the particular terms of their agreement, such as changes related to determination dates, calculation agents and payment dates.[24]

Because of the continually developing array of issues relating to the IBOR transition and the difficulty in capturing all possible reasons that parties may choose to amend their contracts bilaterally rather than enter into the Protocol, the ARRC urges Treasury and the IRS to provide flexible relief with respect to such bilateral incorporation of contractual language comparable to the ISDA fallback provisions.

II. Application of Proposed Regulations to Protocol and Amended Definitions and Request for Targeted Guidance

This section discusses the reasons why the Proposed Regulations do not clearly apply to the Protocol and Amended Definitions, and describes the ARRC's requested relief.

a. The Proposed Regulations, the Protocol and the Amended Definitions

The application of the Proposed Regulations to certain modifications of contracts to adopt or modify a fallback provision, including by adherence to the Protocol or bilateral adoption of the Amended Definitions, may be unclear in certain respects. In particular, the Proposed Regulations provide that no exchange occurs for purposes of Section 1001 of the Code as a result of an amendment to a debt instrument or modification of a non-debt contract to (1) include a qualified rate as a fallback to a rate referencing an IBOR or (2) to replace an IBOR fallback rate with a qualified rate and, in either case, any associated alterations or modifications.[25] A rate is a qualified rate if it satisfies three requirements: (1) the rate is one of a series of enumerated rates, which includes SOFR, (2) the fair market value of the debt instrument or non-debt contract after the alteration or modification is substantially equivalent to the fair market value of the debt instrument or non-debt contract before the alteration or modification or one of the associated safe harbors is met (the "fair market value requirement"), and (3) the replacement rate is based on transactions in the same currency as the IBOR.[26]

The ARRC expects that the amendments to be made pursuant to the Protocol, or comparable bilateral amendments, will satisfy most of the requirements set forth in the Proposed Regulations as a predicate to relief thereunder. For example, the ARRC expects that the new fallback rates will generally fall into the enumerated list of qualified rates included in the Proposed Regulations[27] and that the

[24] Administrative and technical changes are expected to be necessary for many amended OTC derivative contracts that use non-ISDA-based documentation and non-derivative contracts that incorporate the Definitions or use language comparable to the Definitions.
[25] Prop. Reg. § 1.1001-6(a)(3).
[26] Prop. Reg. § 1.1001-6(b).
[27] *See* Prop. Reg. § 1.1001-6(b)(1).

administrative changes made by the ISDA fallback provisions will qualify as "associated alterations or modifications."[28] However, it is not clear whether an amendment made through adherence to the Protocol will satisfy the fair market value requirement.

The preamble to the Proposed Regulations states that the purpose of the fair market value requirement is to ensure that the modifications are limited to those necessary to replace the IBOR with a new reference rate. However, the preamble acknowledges that fair market value may be difficult to determine precisely and therefore the Proposed Regulations provide two safe harbors in order to ease compliance. Under these safe harbors, the fair market value requirement is deemed satisfied if either (1) the historic average of the IBOR and replacement rate are within 25 basis points of each other, taking the spread adjustment into account or (2) the parties are unrelated and determine, based on arm's-length negotiations, that the fair market value of the debt instrument or non-debt contract is substantially equal before and after the alteration or modification.[29]

The existing safe harbors in the Proposed Regulations may not be available to taxpayers who adhere to the Protocol or adopt the Amended Definitions through bilateral agreement. The historic average rates safe harbor requires that, as of the date of the alteration or modification, there be no more than a 25 basis point difference between the historic average of the IBOR and historic average of the replacement rate, taking into account any spread adjustment, as of the date of the modification of the contract.[30] The historic average may be determined using an industry-wide standard, including one recommend by ISDA or the ARRC for purposes of computing the spread adjustment. Alternatively, the historic averages may be determined using any reasonable method that takes into account every instance of the relevant rate published during a continuous period that begins no earlier than 10 years before and ends no earlier than three months before the modification. However, the ISDA fallback provisions included in the Amended Definitions will establish the spread adjustment using a historical period ending on the day before the trigger event date, not the modification date, and therefore the ISDA fallback provisions do not clearly fit within the confines of the safe harbor. Importantly, as described above, the trigger event date will occur sometime (generally unknown) after the date a contract is modified.

Taxpayers adhering to the Protocol also cannot clearly satisfy the second safe harbor, which requires arm's-length negotiations, because the Protocol is designed so that the parties do not negotiate directly. Instead, when both parties to a derivative adhere to the Protocol, the terms of the contract are automatically amended to include the Amended Definitions incorporated into the Protocol. However, while amendments to a derivative contract made through adherence to the Protocol do not involve negotiation between the parties to the contract, the underlying policy goals of this safe harbor—agreement among unrelated market participants—would seem to be met. Specifically, the terms of the Amended Definitions have been determined through a market-wide negotiation of sorts that has

[28] An example of a modification of this type that will be incorporated in the ISDA fallback provisions is the shifting of the observation period for calculating the amount of interest due on a payment date. *See* Prop. Reg. § 1.1001-6(a)(5).
[29] Prop. Reg. § 1.1001-6(b)(2)(ii)(A) & (B).
[30] Prop. Reg. § 1.1001-6(b)(2)(ii).

included regulators, trade organizations and market participants from numerous sectors and countries.[31]

It is possible that the fair market value requirement may be satisfied without the use of a safe harbor (i.e., under the "general test"). However, satisfaction of the general test would require a valuation for each contract modified (either through the Protocol or bilaterally) to include the Amended Definitions. It is important to provide certainty to market participants that adherence to the Protocol or bilateral agreement to include contractual provisions comparable to the Amended Definitions does not cause a taxable exchange to occur for purposes of Section 1001 of the Code, without the need for such valuations.

For the reasons described above, taxpayers adhering to the Protocol or adopting the Amended Definitions through bilateral agreement cannot be certain they will meet the fair market value requirement or come within one of the safe harbors and therefore avoid a taxable exchange. This uncertainty may deter parties from adhering to the Protocol or adopting the Amended Definitions, in particular during the Initial Adherence Period.

b. Requested Guidance

The ARRC requests that Treasury and the IRS issue standalone guidance stating that adherence to the Protocol, as well as bilateral modifications that implement comparable fallback provisions, will not give rise to a taxable event under Section 1001 of the Code. As noted above, the ARRC intends to provide additional comments regarding the Proposed Regulations, including comments addressing the impact of the fair market value requirement in other contexts, but is prioritizing these comments because it understands that the publication of the Protocol is likely to precede the finalization of the Proposed Regulations. Such standalone guidance could be in any form, provided that taxpayers can rely on it.

While the ARRC believes that broad adherence to the Protocol is a critical goal and that such adherence will best facilitate the adoption of more robust fallback provisions into an inordinately large number of legacy derivative contracts, it understands that there are legitimate and commonplace reasons why significant numbers of market participants may choose to enter into comparable contractual modifications on a bilateral basis. Accordingly, the ARRC recommends that the standalone guidance also apply to modifications of contracts that are comparable to the modifications effected by adherence to the Protocol.

The ARRC believes that the nature of the Amended Definitions and the Protocol should allay those concerns of Treasury and the IRS that motivated certain of the predicates for relief under the Proposed Regulations, including the fair market value requirement, and therefore such concerns should not impede the issuance of prompt and broad relief.

The Amended Definitions are intended to be adopted widely by the global market, and are expected to be the industry standard fallback provisions for both bilateral and cleared derivatives, and potentially other types of contracts. They have been developed by ISDA, at the request of international regulators, based on extensive consultations with global market participants and reflect the views of a

[31] *See* notes 8 to 10 above and accompanying text.

variety of participants. In addition, both the applicable rate and the spread adjustment will be calculated and published by Bloomberg based on predetermined formulas.

Because the methodology for calculating the spread adjustment will utilize data as of the trigger event date, which is an unknown date in the future, parties adhering to the Protocol (or entering into comparable bilateral amendments) during the Initial Adherence Period will not be able to predict whether the spread adjustment resulting from the ISDA fallback provisions will operate to their economic benefit or detriment. In addition, because adhering to the Protocol results in a modification of all of the adhering party's ISDA Master Agreements with other adhering parties and modification of an ISDA Master Agreement will generally amend multiple individual derivative transactions, an adhering or amending party will likely modify both "long" and "short" contracts, with the result that the economic consequences of these modifications will not be known at the time of adherence.

The Amended Definitions and the Protocol do not take into account the individual circumstances of any specific contract and therefore cannot include any changes that are unrelated to the incorporation of the more robust ISDA fallback provisions. Accordingly, where a modification is solely to adopt the Amended Definitions or comparable contractual provisions, whether through adherence to the Protocol or by bilateral amendment, the concern that the parties will agree to other changes, unrelated to the replacement of an IBOR, simply does not apply. As a result, the fair market value requirement represents an undue barrier to these types of modifications.

While the technical discussion herein focuses principally on the fair market value requirement because it presents a clear impediment to relief under the Proposed Regulations in this context, the ARRC believes that standalone guidance regarding the Protocol and the Amended Definitions should apply broadly and not address the fair market value requirement alone. Such broad guidance would eliminate any uncertainty market participants may otherwise have that adherence or amendment may trigger taxable events, uncertainty that could unnecessarily hinder adherence.

Accordingly, the ARRC requests interim guidance that would state that the modification of a contract, either through adherence to the Protocol or the entry into comparable bilateral modifications, is not a taxable event under Section 1001 of the Code. In order to reduce impediments to timely adherence to the Protocol or adoption of the Amended Definitions, the ARRC urges Treasury and the IRS to provide such guidance as soon as possible and in any case by February 2020.

c. Proposed Language

Attached to this letter as Appendix A is draft language that could serve as the basis for the guidance requested herein.

Appendix A

Proposed Guidance with Respect to Adherence to the ISDA Protocol

Section 1

If a contract[32] is modified as described in Section 2 of this [revenue procedure]/[notice], the modification will not be treated as an exchange of property for other property differing materially in kind or extent for purposes of Treasury Regulations section 1.1001-1(a).

Section 2

A contract is modified as described in this Section 2 if

(a) both parties to such contract adhere to a protocol published by the International Swaps and Derivatives Association regarding certain definitions providing new benchmark fallback reference rates for Inter-Bank Offered Rates (the "Protocol"), and as a result of such adherence the provisions of the Protocol are incorporated into the terms of the contract; or

(b) the terms of the contract are otherwise amended to incorporate provisions that are comparable to the provisions that would be incorporated into the contract if the parties to the contract were to adhere to the Protocol.

[32] As described in note 23, parties may wish to simultaneously adhere to the Protocol to amend their legacy derivative contracts and amend debt instruments hedged by such derivative contracts in a manner that is comparable to the Protocol. If the guidance requested herein covers such debt instruments, there would be no uncertainty regarding the tax consequences of amendments of such debt instruments and more market participants would be expected to adhere to the Protocol.

Appendix B

Hypothetical timeline for the replacement of a relevant IBOR with a new fallback rate in an ISDA-based contract[33]

- 2019: Party A and Party B enter into an ISDA contract referencing USD three-month LIBOR and incorporating the existing Definitions
- February 1, 2020: ISDA releases Amended Definitions and Protocol, marking the beginning of the Initial Adherence Period
- February 5, 2020: Party A submits its adherence letter to ISDA
- March 1, 2020: Party B submits its adherence letter to ISDA
- May 1, 2020: Initial Adherence Period concludes
- May 1, 2020: ISDA contract between Party A and Party B is modified by operation of the Protocol to include Amended Definitions
- January 1, 2022: The U.K. Financial Conduct Authority or Intercontinental Exchange announces that LIBOR will cease to be published for any dates following March 31, 2022 ("trigger event")
    - Bloomberg calculates relevant spread adjustment between USD three-month LIBOR and USD three-month compounded SOFR based on SOFR data for the five-year period from January 1, 2017 to December 31, 2021 (the "spread adjustment")
- April 1, 2022: Reference rate of ISDA contract between Party A and Party B is automatically amended to reference USD three-month compounded SOFR for any go-forward payments based on rates published on or after April 1, 2022 ("replacement date"), plus the spread adjustment published by Bloomberg

[33] Note that this example is included for illustrative purposes only and **<u>is not an indication of the actual dates</u>** on which the anticipated events will occur.

December 9, 2019

Appendix C

ISDA Supplemental Letter to the Antitrust Division of the Department of Justice

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October 23, 2019

Re: *Supplement to International Swaps & Derivatives Association, Inc.'s Request for Business Review Letter*

Makan Delrahim
Assistant Attorney General
U.S. Department of Justice
Antitrust Division
Main Justice Building
Room 3109
950 Pennsylvania Avenue NW
Washington, DC 20001

Dear Mr. Delrahim:

The International Swaps and Derivatives Association, Inc. ("ISDA")[1] provides the below supplemental information in support of its June 4, 2019 business review letter request concerning ISDA's plan to amend its standardized documentation to account for the potential discontinuation of LIBOR and other interbank offered rates (collectively referred to as "IBORs").

<u>Executive Summary</u>

On June 4, 2019, ISDA submitted a business review letter request asking that the Department's Antitrust Division issue a statement indicating that it is not presently inclined to bring an enforcement action against ISDA for the adoption of certain methodologies to account for any differences between the IBORs and the relevant risk-free interest rate benchmarks ("RFRs") that would apply if an IBOR is permanently discontinued and fallbacks to the adjusted RFRs apply in contracts that reference the discontinued RFR. The June 4 letter

[1] For purposes of this letter, ISDA is defined to include the Association, its Board, any Board committee and any Board or Board committee member acting in that capacity.

provided background on IBORs and the role that they play in the derivatives markets, the way IBORs are incorporated into ISDA's standard documentation, and how ISDA's proposed fallback methodology would involve changes to ISDA's standard documentation. In support of ISDA's request, the letter detailed the steps that ISDA took to evaluate and analyze potential options for addressing the discontinuation of IBORs, the public consultation that ISDA issued in 2018 ("2018 Consultation") to gather market feedback, and the general consensus reflected in the 2018 Consultation regarding how to address the potential discontinuation of IBORs. Finally, the letter explained the changes that ISDA intends to make to its standard documentation to account for the potential discontinuation of IBORs, and other steps that ISDA intends to take to effectuate changes to the fallback methodology.

In response to the 2018 Consultation, an overwhelming majority of respondents identified the "compounded setting in arrears rate" and "historical mean/median" approaches as the preferred methods for addressing the technical issues associated with fallbacks for the IBORs specified in that consultation.[2] ISDA engaged The Brattle Group ("Brattle") to provide an independent overview, summary, and analysis of market participants' responses to the 2018 Consultation. A review of the respondents' comments as summarized in the Brattle Report revealed no significant problems or concerns with the consensus view, confirming that it would be a workable solution that mitigates certain risks involving potential market manipulation, value transfers, and other concerns. Accordingly, ISDA made plans to move forward with the consensus view for the specified IBORs.

In May 2019, ISDA launched a supplemental consultation (the "Supplemental Fallback Consultation") in order to determine whether the consensus view from the 2018 Consultation would also work for fallbacks for USD LIBOR, Canadian IBOR ("CDOR"), and Hong Kong IBOR ("HIBOR").[3]

Also in May 2019, ISDA issued a second consultation – the "Pre-Cessation Consultation" – which sought input from market participants regarding whether ISDA should

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[2] GBP LIBOR, CHR LIBOR, JPY LIBOR, TIBOR Euroyen, TIBOR and BBSW.

[3] ISDA waited to consult on these other fallbacks because the secured overnight financing rate ("SOFR"), which is the fallback RFR for USD LIBOR, was not produced until April 2018 (only three months before the 2018 Consultation) and because the relevant private-public sector working groups were still consulting on reforms to the RFRs for CDOR and HIBOR in 2018, ISDA waited to consult on USD LIBOR, CDOR, and HIBOR so that market participants would have more information about the RFRs.

As part of the 2018 Consultation, ISDA previewed that it would be launching a supplemental consultation seeking the additional input needed from market participants regarding a potential fallback methodology for other benchmarks including USD LIBOR.

address possible "pre-cessation" events based on a public statement from a regulator that an IBOR is no longer representative of the market even though it has not yet been permanently discontinued. The Financial Stability Board Official Sector Steering Group ("FSB OSSG") specifically requested that ISDA undertake the Pre-Cessation Consultation, and ISDA has informed the FSB OSSG of the scope, timing, and substance of the responses.

Both the Supplemental Fallback Consultation and Pre-Cessation Consultation closed on July 12, 2019.

As detailed below, the vast majority (approximately 92%) of respondents to the Supplemental Fallback Consultation expressed a preference—consistent with the market consensus responses to the 2018 Consultation—to use the compounded setting in arrears rate with the historical mean/median approach for the relevant fallback benchmarks (*i.e.*, USD LIBOR, CDOR, and HIBOR). ISDA therefore intends to proceed with developing fallbacks based on the compounded setting in arrears rate and the historical mean/median approach for USD LIBOR, CDOR, and HIBOR fallbacks, for inclusion in the 2006 ISDA Definitions.

The Pre-cessation Consultation however, did not yield a consensus among market participants on how best to address a "pre-cessation" event based on a public announcement by a regulator that an IBOR was no longer representative of the market. While a majority of respondents stated that they would not be content to continue referencing unrepresentative IBORs in new contracts (71.9%) or legacy contracts (64.0%) following a public statement by a regulator that the IBOR was unrepresentative, there was a wide diversity of opinions on how to respond to such an event. A healthy majority of respondents (64.07%) were in favor of utilizing a pre-cessation trigger to address this issue, but even within this group there were different views of how a pre-cessation trigger should be drafted, implemented, and executed—in particular, there was disagreement on whether there should be flexibility to apply to trigger to some but not all transactions. Because the consultation did not generate a consensus regarding how a pre-cessation trigger should be drafted, ISDA continues to discuss next steps with the FSB OSSG.

As with the 2018 Consultation, ISDA made substantial efforts, described below, to ensure that the two consultations issued in May 2019 were fair, transparent, and objective, and that neither the processes nor the results were the product of anticompetitive conduct. Thus, ISDA respectfully submits that, as with the 2018 Consultation, its collaboration with market participants via the two 2019 consultations and its work incorporating the results of those consultations into its standard documentation should not be subject to enforcement by the Department's Antitrust Division.

I. The Supplemental Fallback Consultation

A. Purpose and Format of the Consultation

The Supplemental Fallback Consultation built on the 2018 Consultation and asked whether market participants viewed the most-preferred approach in the 2018 Consultation—compounded setting in arrears rate with the historical mean/median approach—as suitable for USD LIBOR, CDOR, and HIBOR. The Supplemental Fallback Consultation allowed those market participants who participated in the 2018 Consultation to affirm, expand on, or modify their prior answers. The Supplemental Fallback Consultation also presented new questions related to SOFR, including (i) whether it would be appropriate to rely on indicative SOFR values and the historical Overnight Treasury GC Repo Primary Dealer Survey Rate (which serves as a proxy for the SOFR) and (ii) whether the SOFR should be used as an input to calculate a fallback for the SOR in the event that SOR is discontinued because USD LIBOR is discontinued.

On May 16, 2019, the Supplemental Fallback Consultation was publicly released as a market survey on ISDA's website, and was available to all market participants.[4] The consultation provided background information about the FBS OSSG's request for ISDA to participate in work regarding the selection of fallbacks for key benchmarks. To educate respondents, the consultation explained that the current fallbacks to USD LIBOR, CDOR, and HIBOR were not designed to account for permanent discontinuations of those IBORs, outlined how a permanent cessation would be defined and how fallbacks could be triggered. The Supplemental Fallback Consultation detailed the fallback adjustment options for USD LIBOR, CDOR, and HIBOR and referred the market participants to the 2018 Consultation for additional information about the potential advantages and disadvantages of these options.

The Supplemental Fallback Consultation further detailed ISDA's intentions to amend the 2006 ISDA Definitions to include fallbacks to account for the potential discontinuation of relevant IBORs, and to utilize a third-party vendor[5] to calculate and publish the adjusted RFR and spread adjustment so that users can access that information in the same way that they access the relevant IBOR or RFR. It was also explained that if the results of the Supplemental Fallback Consultation were consistent with the 2018 Consultation, then the selected vendor will also build out and finalize the approaches for USD LIBOR, CDOR, and HIBOR.

The Supplemental Fallback Consultation provided a form template for use by the respondents, but also accepted responses in alternative formats such as narrative letters. The consultation was opened on May 16, 2019 and closed on July 12, 2019. As with the 2018 Consultation, Brattle was retained to provide an independent review, analysis, and a summary of the responses to the consultation. On September 18, 2019, Brattle published a report ("Supplemental Fallback Consultation Report"), attached hereto, summarizing the responses to the consultation and reporting the representativeness of the consultation responses.

B. Results of the Consultation

As fully detailed in the Supplemental Fallback Consultation Report, an overwhelming majority (approximately 90%) of respondents expressed a preference to use the compounded

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4 The Supplemental Fallback Consultation can be viewed at https://www.isda.org/a/n6tME/Supplemental-Consultation-on-USD-LIBOR-CDOR-HIBOR-and-SOR.pdf

5 As discussed below, ISDA has subsequently announced the selection of Bloomberg to fulfill this role. A press release with this information can be viewed at https://www.isda.org/2019/07/31/bloomberg-selected-as-fallback-adjustment-vendor/

setting in arrears rate with the historical mean/median approach for USD LIBOR, CDOR, and HIBOR fallbacks. Many of these respondents cited the need for a consistent fallback adjustment methodology across the different benchmarks as an important reason for their preference. Respondents also reiterated the advantages of the compounded setting in arrears rate with historical mean/median approach, consistent with the 2018 Consultation responses. A few respondents did express concerns and potential operational challenges associated with the compounded setting in arrears rate in particular, which were similar to those raised by respondents in the 2018 Consultation. Nevertheless, Brattle's analysis shows that the large majority of respondents did not share those same concerns

Recognizing that the historical mean/median approach requires the use of historical data related to SOFR to calculate the spread adjustment for USD LIBOR fallbacks, and that the Federal Reserve Bank of New York only began publishing SOFR in April 2018, the consultation asked if it would be acceptable to use indicative SOFR and the historical Overnight Treasury GC Repo Primary Dealer Survey Rate (which serves as a proxy for the SOFR) to calculate the spread adjustment for lookback periods starting prior to April 2018. The majority of respondents (approximately 60%) agreed with this approach. Some of these respondents noted that the use of proxy and indicative data is acceptable because there is no other obvious alternative, while others viewed the indicative and proxy data as representative of what the SOFR would have been and/or as the best data available. Some respondents indicated that they agree with using the indicative and proxy data because they preferred a longer lookback period (*i.e.*, 10 years or more). A few respondents agreed in principle with using both the indicative and proxy data, but wanted further analysis to be conducted to determine whether the proxy data is "relevant" to the SOFR. Other respondents were comfortable with the use of the indicative data, but not necessarily the proxy data. Those that preferred a shorter lookback period tended not to think the proxy data would be needed, and therefore considered the point moot. Others specifically highlighted the differences in characteristics between the SOFR and the proxy data that render the proxy data unacceptable. Only a few respondents objected to the use of both the indicative data and the proxy data.

C. ISDA's Implementation Plan

Based on the responses to the Supplemental Fallback Consultation, ISDA intends to proceed with developing fallbacks based on the compounded setting in arrears rate and the historical mean/median approach for USD LIBOR, CDOR, and HIBOR fallbacks to be included in the 2006 ISDA Definitions. ISDA intends to continue soliciting feedback from market participants and working with its independent advisors to determine the appropriate parameters for the historical mean/median approach and precise equations that will be used to calculate the adjustment. ISDA released a public consultation on these issues on September 18, 2019.[6]

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[6] The consultation can be viewed at https://www.isda.org/2019/09/18/september-2019-consultation-on-final-parameters/.

In July 2019, ISDA announced its selection of Bloomberg to calculate and publish adjustments to the IBOR fallbacks at issue in the 2018 Consultation. Bloomberg was selected through a public invitation to tender published in February 2019.[7] The selection process was run by ISDA with input from a selection committee with members representing both buy- and sell-side market participants.

ISDA has provided the relevant feedback from the Supplemental Fallback Consultation regarding SOR to the Monetary Authority of Singapore ("MAS"), the Singapore Foreign Exchange Market Committee ("SFEMC") and ABS Benchmark Administration Co Pte Ltd ("ABS Co") for their consideration as they determine how to address the implication of the permanent cessation of USD LIBOR on SOR. If the SFEMC and ABS Co determine that a fallback to a rate such as "Adjusted SOR" is appropriate and that rate is produced and published (or will be produced and published), ISDA expects to update SGD-SOR-VWAP Rate Option in Section 7.1 of the 2006 ISDA Definitions to include a contractual fallback to that rate.

II. The Pre-Cessation Consultation

A. Purpose and Format of the Consultation

In early 2019, statements by the UK Financial Conduct Authority (FCA) indicated that if the FCA determined that one or more LIBOR panels shrunk so significantly that the relevant rate was no longer capable of being representative, then the FCA would make a statement that such a benchmark is no longer representative.[8] In light of this, the FSB OSSG suggested that, in addition to incorporating fallback triggers based on permanent cessation, market participants may wish to consider including in their LIBOR contracts "pre-cessation" fallback triggers based on an announcement by the FCA that LIBOR is no longer representative. If pre-cessation triggers are included, contracts referencing LIBOR would move to the adjusted RFR fallback rates upon the pre-cessation event, even if LIBOR continues to be published. In a March 2019 letter to ISDA, the FSB OSSG co-chairs specifically asked that ISDA consult on a potential trigger for fallbacks that would take effect in the event that the FCA found LIBOR to be non-representative and made a statement to that effect, noting that "the EU Benchmarks Regulation envisages some circumstances in which a critical benchmark that does not meet requirements of the Regulation (such as representativeness) continues to be published but EU supervised entities would no longer be able to enter into new derivative or securities transactions referencing LIBOR in such circumstances."[9]

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[7] The press release regarding the invitation to tender can be viewed at https://www.isda.org/a/F9gME/IBOR-Fallback-Admin-RFP-Press-Release.pdf.

[8] https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks.

[9] http://www.fsb.org/wp-content/uploads/P150319.pdf.

The Pre-Cessation Consultation sought input from market participants on the preferred approach for addressing pre-cessation issues in derivatives that reference LIBOR and other key IBORs, including in the context of a regulator's statement that the relevant IBOR is no longer representative. Specifically, the consultation sought feedback from market participants regarding possible approaches to inclusion of a pre-cessation trigger in the 2006 ISDA Definitions and/or the protocol that ISDA intends to publish to address fallbacks for legacy transactions.[10] To educate respondents, the Pre-Cessation Consultation provided background information regarding these potential approaches and potential challenges to implementation of a pre-cessation trigger related to representativeness.

First, the consultation addressed the potential implications of a pre-cessation trigger on cash products and derivatives used to hedge cash products, and the risk of mismatches between a product and its derivative. The Pre-Cessation Consultation noted that because derivatives often are used to hedge cash products, market participants may want to apply the same triggers and fallbacks across cleared and non-cleared derivatives and in the relevant cash products and related derivative to avoid a mismatch (*e.g.*, the cash product moving to a new benchmark but the derivative does not, or vice versa). If new cash products include pre-cessation triggers, market participants may want to consider including pre-cessation triggers and corresponding fallbacks in new derivatives that hedge those cash products. Similarly, if new or existing cash products do not include pre-cessation triggers and fallbacks, market participants may prefer not to include pre-cessation triggers and fallbacks in derivatives that hedge those cash products.

Certain public-private sector RFR working groups, such as the Alternative Reference Rates Committee (ARRC) in the United States, have consulted on and published template fallback language for new cash products which includes non-representative "pre-cessation" triggers for USD LIBOR. However, not all public-private sector RFR working groups have explicitly considered or taken a view on fallbacks for cash products and whether a pre-cessation trigger relating to representativeness should be included in such fallbacks. It is also unclear whether market participants would be able to include a pre-cessation trigger in existing cash products, as many legacy cash products are difficult or impossible to amend.

CME and LCH have each communicated to ISDA and regulators that, subject to the detail and feedback of the Pre-cessation Consultation, they believe that market efficiencies could be achieved by aligning how cleared derivatives operate with a pre-cessation trigger for fallbacks in non-cleared contracts if the 2006 ISDA Definitions were to include such a trigger. However, at the same time, CME and LCH have each also communicated to ISDA and regulators that they may elect to consider pre-cessation triggers for fallbacks if LIBOR is

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10 As previously discussed, ISDA intends to amend its standard documentation to implement fallback reference rates for certain key IBORs, including LIBOR, to protect against the risk that those IBORs could cease at some point in the future. ISDA intends to amend and restate the "rate options" in the 2006 ISDA Definitions in order to ensure that if certain IBORs cease, the fallbacks will apply in derivatives transactions executed on or after the effective date of the amendments and incorporate the 2006 ISDA Definitions. To address pre-existing (legacy) derivatives transactions, ISDA intends to publish a protocol to facilitate the inclusion of fallbacks that incorporate the 2006 ISDA Definitions. Adherence to such a protocol will be strictly voluntary.

found to be non-representative, even if the 2006 ISDA Definitions do not include them. Thus, ISDA also noted in the Pre-Cessation Consultation that mismatches could occur in a variety of situations in which the relevant triggers and fallbacks do not completely align and solicited input from market participants regarding this potential issue.

Second, the Pre-Cessation Consultation noted that if a relevant regulator states that a benchmark is no longer representative, then that would not, in and of itself, result in the prohibition on the use of a benchmark under the EU Benchmarks Regulation, market participants using that benchmark in derivatives may nevertheless wish to cease using that benchmark following such a statement. Market participants in the jurisdiction of the regulator making the statement particularly might prefer to cease using the benchmark (or may be required to do so), and any market participants that choose to stop using the benchmark in new transactions also may want to amend certain existing transactions that reference the benchmark, as appropriate. The consultation noted that under such circumstances, counterparties who converted to the fallback rate would be able to determine whether they are receiving/paying more or less on the basis of the fallback rate compared to the unrepresentative IBOR, and solicited views from market participants regarding this potential situation.

Third, the Pre-Cessation Consultation raised the possibility that the addition of a pre-cessation trigger could introduce a disparity between spread adjustments in derivative contracts. If a regulator made a statement that an IBOR is no longer representative and, as a result, derivative contracts are amended to reference the fallback rate at the time the relevant regulator makes such a statement, and the relevant IBOR is subsequently permanently discontinued following an index cessation event, the spread that would apply for the permanent cessation fallbacks would differ from the spread that applied for the pre-cessation fallbacks. The consultation also solicited feedback from market participants regarding this potential issue.

The Pre-cessation Consultation was released on May 16, 2019 and closed on July 12, 2019. ISDA provided a form template for use by the respondents, but also accepted responses in alternative formats such as narrative letters. The consultation featured twenty questions designed to elicit robust narrative feedback from market participants, including potential advantages and disadvantages of including or excluding a pre-cessation trigger from the 2006 ISDA Definitions and/or an amendment protocol to introduce IBOR fallbacks.

B. Results of the Consultation

A significant majority of respondents (71.9%) stated that they would not be content to continue using an IBOR in <u>new</u> derivatives contracts following a statement regarding unrepresentativeness. A smaller majority of respondents (64.0%) stated that they would not be content to continue to have <u>legacy</u> contracts (i.e., contracts that could contain contractual fallbacks) that reference an IBOR following a statement regarding unrepresentativeness, but nearly half of those respondents (45.6%) indicated that they may nonetheless continue referencing an unrepresentative IBOR under certain circumstances.

The responses to the Pre-cessation Consultation indicated that market participants broadly desire a uniform transition to fallback rates across products and currencies. However, the respondents expressed a wide variety of views regarding whether and how to implement a pre-cessation trigger related to non-representativeness for derivatives:

- 14.6% of respondents generally supported adding a pre-cessation trigger to the permanent cessation triggers in a "hard wired" amendment to the 2006 ISDA Definitions and related protocol but did not specifically address a preference regarding optionality or flexibility.

- 26.97% of respondents supported the inclusion of a pre-cessation trigger in the 2006 ISDA Definitions and opposed the publication of a protocol with optionality or flexibility.

- 22.5% of respondents supported the inclusion of a pre-cessation trigger in the 2006 ISDA Definitions and supported implemented with optionality and flexibility.

- 28.1% of respondents opposed the use of a pre-cessation trigger.

- 7.9% of respondents gave non-committal or unresponsive answers to whether a pre-cessation trigger should be implemented.

C. ISDA's Implementation Plan

Because the Pre-cessation Consultation did not yield a consensus regarding how a pre-cessation trigger should be utilized, ISDA will not at this time incorporate a pre-cessation trigger into the 2006 ISDA Definitions. ISDA continues to discuss issues related to pre-cessation with the FSB OSSG.

III. The Supplemental Fallback Consultation and Pre-cessation Consultation Will Improve Market Stability and Efficiency

ISDA is confident that the output for the Supplemental Fallback Consultation will be useful and important tools for market participants and will promote a safer and more stable market. ISDA also believes that its consultation processes for both the Supplemental Fallback Consultation and Pre-cessation Consultation were fair and procompetitive, and therefore should not be subject to enforcement by the Department's Antitrust Division. As described in further detail below, the consultations were conducted at the behest of international regulators and featured open, robust, and transparent processes designed to engage a wide array of global market participants. Throughout the consultation processes, ISDA took steps to educate and engage market participants while using safeguards such as the involvement of antitrust counsel and third party consultants to ensure that information was shared appropriately.

First, ISDA conducted the consultations at the request of international regulators, who recognized the importance of assessing market opinions regarding fallback methodologies and procedures. The Supplemental Fallback Consultation was conducted in response to requests from the FSB OSSG that ISDA take a leading role in increasing derivative contract robustness by developing fallbacks in its Definitions for key IBORs. The Pre-Cessation Consultation was initiated at the request of the FSB OSSG, which requested that ISDA seek market opinions regarding a pre-cessation trigger based on representativeness.[11] ISDA remained engaged with the regulators regarding the progress of the consultations and its intended next steps.

Second, each consultation featured an open and transparent process. Both consultations were designed to elicit narrative feedback from market participants and to avoid limiting or steering the responses in any way. The Supplemental Fallback Consultation built upon the 2018 Consultation, which was the result of an iterative process described in the June 4, 2019 business review letter request. The Pre-Cessation Consultation featured open-ended questions that permitted respondents to provide their responses as free-form text. It also identified potential advantages to and drawbacks of various approaches to the implementation of a pre-cessation trigger, and solicited feedback as to these various approaches and issues. ISDA published a webinar to introduce each consultation and accepted questions from respondents throughout both supplemental consultations.

Third, each consultation featured procedural safeguards. ISDA engaged an independent third party, Brattle, as well as outside counsel to assess the responses to both supplemental consultations. As part of their analysis, Brattle and ISDA's outside counsel anonymized and aggregated the responses in order to ensure that information was shared appropriately.

Fourth, each consultation was robust. Both consultations garnered a high number of responses from a broad range of market participants and reflected input from a mixture of entity types and perspectives. For the Supplemental Fallback Consultation, Brattle reviewed responses from a total of 89 entities, collectively from 16 countries across Europe, Asia-Pacific, and the Americas. The responding entities operate in a number of sectors and included banks, asset managers, pension funds, corporate entities, central counterparties, global financial service firms, and government entities. Similarly, the Pre-cessation Consultation elicited a variety of perspectives from a broad group of market participants. ISDA's outside counsel and Brattle reviewed a total of 86 responses,[12] from 89 respondents, including banks, asset managers, pension funds, corporate entities, central counterparties, global financial service firms, and government entities from 16 countries across Europe, Asia-Pacific, Africa, and the Americas.

Fifth, ISDA's methodology will not be binding on market participants with legacy derivatives contracts referencing the relevant IBORs. There will always remain optionality

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11 *See* Letter from Andrew Bailey (U.K. Financial Conduct Authority) and John Williams (Federal Reserve Bank of New York) to ISDA, dated March 12, 2019, available at https://www.fsb.org/wp-content/uploads/P150319.pdf

12 Six responses from trade/industry associations were reviewed but excluded from the total because they did not identify the members whose opinions were represented in the response. One respondent submitted a response on behalf of four banks, and therefore was considered four responses.

with respect to how individual counter-parties choose to amend their contracts, and ISDA cannot and will not be in a position to ensure that all market participants use the fallbacks in the ISDA Definitions as a starting point for those discussions. ISDA is merely offering a fallback methodology – not a fixed price. Nevertheless, ISDA's expectation is that there will be significant adoption of the fallback methodology.

IV. Conclusion

We would be pleased to answer any questions or provide any additional information that may assist in your assessment of this request.

We also attach for your review and consideration the *Summary of Responses to the ISDA Supplemental Consultation on Spread and Term Adjustments* report by Brattle, dated September 18, 2019 and the *Anonymized Narrative Summary of Responses to the ISDA Pre-Cessation Consultation* report by Brattle, dated October 21, 2019.

Thank you for your consideration.

Respectfully submitted,

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Appendix D

ISDA Letter to the Antitrust Division of the Department of Justice

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June 4, 2019

Re: *International Swaps & Derivatives Association, Inc.'s Request for Business Review Letter, File No. 60-523999-0010*

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Washington, DC 20001

Dear Mr. Delrahim:

The International Swaps and Derivatives Association, Inc. ("ISDA") requests a business review letter pursuant to C.F.R. § 50.6 concerning ISDA's plan to amend its standardized documentation to account for the potential discontinuation of LIBOR and other interbank offered rates (collectively referred to as "IBORs").

Executive Summary

ISDA is a trade association whose members include a broad range of derivatives market participants, such as international, regional and specialized banks, corporations, investment managers, government and supranational entities, insurance companies, and other firms. ISDA's work focuses on reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure. One significant component of ISDA's work has been to develop standard contractual documentation that may be voluntarily used by market participants. ISDA's standard documentation provides the standard contractual terms in the global market for interest rate and other derivatives. A significant portion of those interest rate and other derivatives incorporate IBORs into their standard terms and conditions.

In the wake of allegations of potentially fraudulent or improper behavior with respect to the LIBOR-submission process, regulators in and outside of the U.S. urged the market to identify and adopt risk-free or nearly risk-free interest rate benchmarks ("RFRs") as alternatives to LIBOR and other key IBORs to account for the possibility that IBORs may be discontinued. A failure to account for the potential discontinuation of IBORs poses a serious risk of frustrating existing contracts that reference IBORs, and could have rippling, negative effects on the U.S. and global economies. In order to mitigate these risks, and at the request of regulators, ISDA has worked closely with a broad range of industry participants to develop a fallback methodology (i.e., a methodology that prepares for the discontinuation of IBORs) that will cause the least amount of disruption, is the least susceptible to manipulation, and ensures the most commercially reasonable outcome. ISDA's proposed fallback methodology has, to date, garnered incredible consensus among industry participants, reflecting that the proposed fallback methodology will be well and timely received by industry participants.

Because ISDA's members are competitors in certain markets, the Association's work to develop a proposed fallback methodology could be viewed as coordination among competitors. In particular, ISDA has worked with industry participants to develop a methodology that attempts to account for the inherent differences between the IBORs and the relevant RFRs. In short, that methodology attempts to approximate the differences between the IBORs and the relevant RFRs. As described more fully below, the methodology applies a "term adjustment" and "spread adjustment" (representing the "risk premium" in the IBORs) to the relevant RFRs, and ISDA has worked with industry participants to develop the preferred term adjustment and spread adjustment calculations.

For the reasons outlined in this letter, ISDA respectfully submits that this coordination by ISDA and market participants should not be subject to enforcement by the Antitrust Division. ISDA has taken substantial efforts, described in detail below, to ensure that its process was fair, transparent, and objective, and that neither the process nor its resulting methodology was the product of anticompetitive conduct. ISDA believes that its process represents procompetitive efforts to ensure a safer and more efficient marketplace, and therefore believes that no violation of the antitrust laws has occurred by or through ISDA's processes.

<u>Introduction</u>

ISDA respectfully requests that the Antitrust Division issue a statement indicating that it is not presently inclined to bring an enforcement action against ISDA's adoption of certain methodologies to account for differences between the IBORs and the relevant RFR that would apply if an IBOR is permanently discontinued and the impact that these differences would have on contracts referencing that IBOR.[1] In support of this request, this letter provides background on IBORs, the role they play in the derivatives markets, the way IBORs are incorporated into ISDA's standard documentation, and how ISDA's proposed

[1] For purposes of this letter, ISDA is defined to include the Association, its Board, any Board committee, and any Board or Board committee member acting in that capacity.

fallback methodology will center around proposed changes to ISDA's standard documentation. Part I starts by describing the role ISDA plays in the industry, the history and role of IBORs in derivatives, and the nature and use of ISDA's standard documentation in derivatives transactions. Part II then outlines the risks presented by the potential discontinuation of IBORs and the significant negative consequences that the discontinuation of IBORs could have on derivatives transactions. Part III describes the steps ISDA took to evaluate and analyze the possible methods for addressing the discontinuation of IBORs, and the general consensus around how to address that problem. Finally, Part IV outlines the proposed fallback methodology, with a focus on the changes to ISDA's standard documentation and the steps that ISDA will take to effectuate those changes. Because this letter contains commercially sensitive operational details and strategy, the disclosure of which would have a detrimental effect on ISDA and its members, ISDA requests confidential treatment to the fullest extent provided for by 28 C.F.R. § 50.6(10)(c).

I. Factual Background

a. ISDA

ISDA is a trade association that was created in 1985 to make global derivatives markets safer and more efficient. ISDA has over 900 member institutions from 71 countries. Membership is comprised of a broad range of derivatives market participants: international, regional and specialized banks, corporations, investment managers, government and supranational entities, insurance companies, and other firms. Members also include key components of the derivatives market infrastructure, including financial technology firms, trading platforms, exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work focuses on reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure for all market participants.

ISDA has pioneered industry-standardized documentation for derivatives transactions, promoted sound risk management practices and processes, and engaged with policymakers and industry participants to assess and implement regulatory reform. ISDA's first major standardization work was the ISDA Master Agreement, which remains a standard document for derivatives transactions today. Utilization of ISDA's standardized documentation by market participants is entirely voluntary, but ISDA's documentation is widely used as a starting point for bilateral negotiations because it increases efficiency and reduces costs. As a practical matter, even though ISDA's documents remain voluntary, ISDA has typically seen wide-spread adoption of most of ISDA's standardized terms and conditions and, in some cases, these terms and conditions are hardwired in derivatives market infrastructure.

b. Interbank Offered Rates ("IBORs")

Although the IBORs are not all defined the same, they are generally intended to represent the average rate at which certain identified banks (called "panel banks") could borrow money in various currencies in the interbank market on an unsecured basis for a given period of time, known as a "tenor." Tenors can vary from overnight to months. Different administrators produce and publish the different IBORs. For example, LIBOR, also known today as ICE LIBOR, is the most widely used reference rate, and is intended to reflect London interbank lending rates for Eurodollars. Today, LIBOR is administrated by the ICE Benchmark Administration, a subsidiary of the Intercontinental Exchange. LIBOR is currently produced across five currencies and numerous tenors spanning from overnight to twelve months. IBORs are used for many purposes in the global financial system, including as reference rates in financial transactions. In these cases, the IBORs are used to determine the amounts owed to or by the parties to those financial transactions.

The process by which each IBOR is set differs by currency, but generally speaking, each panel bank submits, for each tenor on each day, the rate at which it could expect to borrow funds in that currency in the interbank market. An administrator collects all of the rates submitted by the panel banks, and (after making certain adjustments to cull down the set of submissions) averages all of the rates submitted to produce a single rate for each tenor. Because banks typically fund themselves differently today than they did 30+ years ago, there are far fewer transactions in the interbank markets that LIBOR and other IBORs are intended to represent. Therefore, LIBOR and other IBORs are produced largely based on the rates at which panel banks believe they could borrow in these markets, which in turn is based on a variety of data points and their judgment.

II. ISDA's Standard Documentation and References to IBORs

ISDA's documentation includes several forms of a Master Agreement and various definitional booklets.

- The Master Agreement is a standard contract that can be used to govern over-the-counter ("OTC") derivatives transactions entered into between parties. ISDA publishes the template, which is made available to parties who can choose to bilaterally enter into the Master Agreement to govern their transactions and set out provisions governing their relationship. Transactions across different asset classes and products are often documented using the same Master Agreement.

- The Definitions provide the basic framework for the documentation of the privately-negotiated derivatives transactions. They are intended for use in confirmations of individual transactions governed by ISDA Master Agreements. The 2006 ISDA Definitions specifically address interest rate and currency derivative transactions. The 2006 ISDA Definitions have a mechanism whereby ISDA can publish supplements to update, add or adjust provisions as markets develop.

The 2006 ISDA Definitions contain the "rate options" for the IBORs that serve as the legal definitions of these reference rates in most interest rate derivatives. If LIBOR or another IBOR were to be permanently discontinued, and thus no longer available, then all transactions using the terms in the 2006 ISDA Definitions (and earlier versions of the ISDA Definitions for interest rate and currency derivative transactions) would transition to a fallback mechanism for the calculation of the relevant rate. The current fallback mechanism in ISDA's Definitions is not practical and could lead to widespread market disruption. Specifically, the relevant rate options in ISDA's Definitions currently establish that in the event an IBOR is discontinued, the counterparty that is the "calculation agent" for the transaction must obtain price quotes from major dealers in the relevant market. However, it is unlikely that dealers would be willing and/or able to give such quotes, particularly if the relevant IBOR has been permanently discontinued. Even if quotes were available in the near-term after the discontinuation of the IBOR, it is unlikely that quotes would be available for each future reset date over the remaining tenors of long-dated contracts. (Some derivatives transactions have multi-year terms, and interest rate swaps can last 5, 10, 30 or even more years). And even if dealers provided such quotes, the quotes likely would vary materially across the market and it would be difficult, if not impossible, to obtain such quotes for all of the hundreds of millions notional of derivatives that currently reference IBORs.

If the benchmark rates that are incorporated into these derivatives transactions are unavailable, then potentially catastrophic consequences could ensue. Indeed, these derivatives transactions are often used for hedging purposes, allowing purchasers of interest rate swaps to mitigate against extreme fluctuations in interest rates. If those derivatives transactions become frustrated, then large portions of the economy would be more exposed to market volatility. In all events, the frustration of those contracts could lead to extreme and unintended value transfers between the parties and/or require the bilateral renegotiations of hundreds of trillions of dollars in notional transactions.

In order to mitigate these potentially catastrophic consequences, ISDA has undertaken efforts to make the markets safer and more efficient by seeking a general consensus on how the definitions for various key IBORs should be revised to include specific fallback rates.

III. Uncertain Future for LIBOR

The long history of LIBOR and its reform illustrate that ISDA's work is essential to protecting efficient financial markets. In 2009, the G20 formed the Financial Stability Board ("FSB"), an international body that monitors and makes recommendations about the global financial system. Around that time, allegations emerged that certain panel banks may have engaged in fraudulent or improper behavior with respect to the process of making submissions to the LIBOR administrator, which prompted the FSB and regulators across the globe to investigate the durability and robustness of LIBOR.

In light of this review and given the importance of LIBOR in the global economy,[2] regulators urged the market to identify and adopt risk-free or nearly risk-free interest rate

2 Jerome H. Powell, Federal Reserve Board of Governors, *Reforming U.S. Dollar LIBOR: The Path Forward*, Speech at the Money Marketeers of New York University (Sept. 4, 2014); https://www.federalreserve.gov/newsevents/speech/powell20140904a.htm ("This problem is not just Wall Street's concern; every household with a LIBOR-linked mortgage and every corporation with a LIBOR-linked loan has an interest in more robust U.S. dollar reference rates.").

benchmarks ("RFRs") as alternatives to LIBOR and other key IBORs.[3] In 2013, the FSB established the Official Sector Steering Group ("OSSG"), comprised of senior officials from central banks and regulatory bodies, to focus specifically on interest rate benchmarks and possible alternative rates. In July 2014, the FSB and OSSG recommended that the alternative rates, to the maximum extent possible, be anchored in actual transactions to avoid the need for submissions from market participants based on judgment and to protect against the potential for manipulation.[4] Public-private sector working groups were established in relevant jurisdictions (e.g., the Alternative Reference Rates Committee, or the "ARRC" in the United States) to carry out this work.

Alongside this work, UK's Financial Conduct Authority ("FCA") and other members of the FSB OSSG, including the US Federal Reserve, have been encouraging market participants to transition away from LIBOR.[5] In July 2017, Andrew Bailey (Chief Executive of the FCA) explained that "it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates [e.g., LIBOR] that do not have active underlying markets to support them."[6] Mr. Bailey announced that panel banks have agreed to sustain LIBOR until the end of 2021 to enable a transition away from the rates that can be planned and executed smoothly.[7]

There are hundreds of trillions of dollars notional in derivatives and other financial products tied to LIBOR through the use of ISDA's Definitions. Therefore, it was logical that the OSSG asked ISDA on July 6, 2016 to lead an initiative to increase derivative contract robustness by developing fallbacks in its Definitions for key IBORs.[8] ISDA understood its implicit assignment: to (1) establish and implement fallback procedures that are sufficiently robust to prevent serious market disruption in the event that an IBOR is permanently discontinued, and (2) ensure that market participants understand these fallback arrangements. On September 7, 2016, ISDA agreed to take on this work, and as illustrated below, ISDA has carried out a process that satisfied the OSSG's objectives.

IV. ISDA's IBOR Reform

a. Risk Free Rates Require Adjustments to Replace IBORs

A threshold matter for ISDA's work was identifying the relevant fallback rates. After discussions with a broad range of industry participants, regulators, and the OSSG,

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3 *Id.* ("[R]egulators need to work with market participants to encourage them to develop and adopt alternative reference rates that better reflect the current structure of U.S. financial markets. . . . Going forward, these alternative rates could replace LIBOR as the reference rate for new interest rate derivatives and some other contracts denominated in U.S. dollars.).

4 Financial Stability Board, Reforming Major Interest Rate Benchmarks (July 22, 2014) http://www.fsb.org/wp-content/uploads/r_140722.pdf.

5 Andrew Bailey, Chief Executive of the FCA, *The Future of LIBOR*, Speech at Bloomberg London, UK (July 27, 2017) https://www.fca.org.uk/news/speeches/the-future-of-libor

6 *Id.*

7 *Id. See also* Andrew Bailey, Chief Executive of the FCA, *FCA statement on LIBOR panels*, Speech (Nov. 24, 2017) https://www.fca.org.uk/news/statements/fca-statement-libor-panels

8 The FSB OSSG also sent letters to ISDA regarding this work on April 18, 2018 and March 12, 2019.

ISDA determined that the RFRs that were identified by relevant public-private sector working groups would be the fallback rates incorporated into ISDA's Definitions for the relevant IBORs. Those RFRs have been selected for most major jurisdictions, and at present include:

Table 1: Public-Private Sector RFR Selections

Jurisdiction	IBOR(s)	Public-Private Sector Working Group	Selected RFR
USA	USD LIBOR	Alternative Reference Rate Committee	SOFR (broad treasuries repo financing rate to be published by NY Fed)
UK	GBP LIBOR	Bank of England Working Group on Sterling Risk-Free Reference Rates	SONIA
Japan	JPY LIBOR TIBOR Euroyen TIBOR	Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks	TONA
Switzerland	CHF LIBOR	National Working Group on Swiss Franc Reference Rates	SARON
Eurozone	EUR LIBOR EURIBOR	Working Group on Euro Risk-Free Rates	€STR
Australia	BBSW	N/A	RBA Cash Rate (AONIA)
Canada	CDOR	Canadian Alternative Reference Rate Working Group	CORRA
Hong Kong	HIBOR	TMA Working Group on Alternative Reference Rates	HONIA

Multiple market participants pointed out, and others agreed, that RFRs technically cannot be substituted directly for IBORs without adjustments. First, IBORs are currently available in multiple tenors, such as one, three, six and twelve months. By contrast, the RFRs are overnight rates. Second, IBORs incorporate a bank credit risk premium and a variety of other factors that RFRs do not capture. Because direct substitution is not possible, ISDA sought to determine how to adjust the RFRs to make them suitable IBOR replacements. To ensure that ISDA understood the potential risks and industry participants' views on how best to account for these two issues—for the differences in "terms" between IBORs and RFRs and the existence of a "risk premium" in IBORs but not in RFRs—ISDA conducted a multi-step, public consultation during the second half of 2018. The results of that consultation form the basis for ISDA's proposed fallback procedures.

b. ISDA's Consultation Generated Market Consensus

To prepare for the consultation, ISDA took steps to ensure that the market survey would be informative and would elicit meaningful feedback from the respondents. When it first undertook the work requested by the FSB OSSG described above, ISDA established four open-membership working groups, organized by currency, to address risks associated with an IBOR discontinuation and draft fallback arrangements. The working groups reported to the ISDA Board Benchmark Committee formed by the ISDA Board of Directors, and included representatives of interest rate swap dealers, interest rate swap end-users, central counterparties, and IBOR benchmark administrators. ISDA also established a separate working group to analyze technical issues that may be necessary when transitioning from an IBOR to an RFR fallback rate. This group included technical experts from the working groups, and was primarily tasked with identifying a range of potential term adjustments and spread adjustment methodologies. The technical group shared their recommendations with the working groups for further consideration, and these recommendations informed the questions and options presented in the consultation. ISDA also engaged and consulted with The Brattle Group on analysis of the implementation items, and tasked The Brattle Group with conducting an independent overview, summary, and analysis of the market responses to the Consultation.

On July 12, 2018, ISDA launched the consultation as a public survey designed to educate the public about the proposed amendments to ISDA's standard documentation and solicit informed recommendations on the term structure and RFR adjustment methodologies. The consultation provided information on alternative options for calculating the term adjusted RFRs (i.e., the RFRs with adjustments for the tenor of the relevant IBOR) and spread adjustments, and asked market participants to rank nine combinations of these options in order of preference and to specify whether their preferences applied universally across the covered IBORs. The consultation also asked market participants about the potential impact of any of the possible combinations on their ability to complete transactions, and prompted them to disclose any concerns if fallbacks were based on different calculations across the covered IBORs. Market participants were asked to comment on the general appropriateness and effectiveness, and potential operational challenges or other barriers to implementation, of the options in the consultation.

ISDA received responses to the consultation from a diverse range of market participants from five continents and 19 countries, reflecting the preferences of 164 entities or respondents.[9] The respondents represent a variety of industry sectors, including banks, asset managers, pension funds, corporate entities, exchanges and clearinghouses, global financial services firms, industry and trade associations and government entities, and thus reflect several different perspectives and businesses.

The results of the consultation confirmed a general market consensus. In almost 90 percent of respondent rankings, the "compounded setting in arrears rate" was selected as the

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9 ISDA received 151 responses from market participants. However, two of these responses consisted of separate sets of answers for different related entities or on behalf of different clienteles, and two responses were exact duplicates of each other, resulting in 152 actual responses by market participants. In addition, two of these responses were from trade associations that explicitly listed the member entities that contributed to the responses. One of these trade associations represented ten member entities and the other represented four member entities. Therefore, collectively, the 152 actual responses came from 164 entities. Of these 164 entities, only responses from 147 were considered when determining fallback option preferences because the other responses were not from named market participants, were incomplete or did not address the IBORs covered by the consultation.

top preference for the term adjusted RFR. The compounded setting in arrears rate consists of the relevant RFR observed over the relevant IBOR tenor and compounded daily during that period. Proponents of this approach highlighted as advantages its compatibility with the overnight index swap ("OIS") market and its ability to reflect the daily interest rate movements during the relevant period. The remaining respondents (but for one) that did not select the compounded setting in arrears rate were not opposed to this approach.

The "historical mean/median approach" to the spread adjustment was selected as the top preference in almost 70 percent of the respondent rankings. The historical mean/median approach is based on the mean or median spread between the relevant IBOR and RFR calculated over a significant, static lookback period (e.g., 5 or 10 years). Proponents of this approach highlighted several advantages, including that: (i) it is robust and simple; (ii) it would reduce the potential for manipulation; and (iii) it is resistant to market distortions. Some respondents expressed concerns with the historical mean/median approach to the spread adjustment, including the potential for a value transfer if the fallbacks are triggered. The concern over value transfer appeared to be the key reason persuading the remaining respondents to select the forward approach to the spread adjustment as their first preference. However, even among the proponents of the forward approach to the spread adjustment, several acknowledged that, relative to the historical mean/median approach to the spread adjustment, there is: (i) more manipulation risk associated with the forward approach; and (ii) concern over uncertainty as to whether there will be sufficient market liquidity in relevant transactions to support the forward approach. In more than half of the respondent rankings in which the forward approach was ranked first, the historical mean/median approach was the next preferred option. As a result, more than 80 percent of respondent rankings included the historical mean/median approach in their top two preferred options.

The consultation that ISDA conducted in 2018 specifically covered GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW. It also asked for preliminary feedback regarding USD LIBOR, EUR LIBOR and EURIBOR and asked respondents to indicate whether their preferences applied to the covered IBORs specifically or to IBORs generally. Approximately 78 percent of respondents found it appropriate to apply the same adjustments to all IBORs.

In order to confirm these results for USD LIBOR, CDOR and HIBOR specifically, ISDA is conducting a supplemental consultation that will close on July 12, 2019.[10] ISDA waited to consult on these IBORs so that market participants would have more information about the RFRs when responding. In the case of USD LIBOR, the fallback RFR, SOFR, was not produced until April 2018, only three months before the 2018 consultation. In the case of CDOR and HIBOR, the relevant public-private sector working groups were still consulting on reforms to the fallback RFRs, CDOR and HIBOR, respectively, in 2018.

[10] At the urging of certain regulators, ISDA also recently launched a consultation seeking input on whether market participants would also like to incorporate a fallback mechanism for the IBORs in the event that the IBORs have been deemed unrepresentative of the market, even though the IBORs continue to be published (i.e., even though the IBORs have not been permanently discontinued). That consultation is also expected to close in July 2019.

ISDA will update the Antitrust Division if the results of the current consultation differ from the results of the 2018 consultation.

The fallback RFR for EUR LIBOR and EURIBOR, which is €STR, will not be produced until October 2019. ISDA expects to confirm the results of the 2018 consultation for EUR LIBOR and EURIBOR sometime at the end of 2019 or in early 2020, after €STR begins trading. As a result, ISDA will implement fallbacks for EUR LIBOR and EURIBOR on a delayed timetable.

c. ISDA's Implementation Plan

As it has done for prior amendments, ISDA intends to publish a "Supplement" in order to amend and restate the relevant rate options in the 2006 ISDA Definitions to include the new fallback rates and adjustment methodology. Specifically, the Amendments will apply to the rate options in Section 7.1 of the Definitions. Upon the effective date of the Supplement, all transactions moving forward that reference the relevant IBORs and incorporate the 2006 ISDA Definitions will include the amended rate option (i.e., the rate option with the fallback). Transactions entered into prior to the effective date of the Supplement (so called "legacy derivatives contracts") will not be covered by the Supplement and will therefore not contain the fallbacks.

ISDA also intends to publish a protocol to assist parties who voluntarily adhere to the amended and restated rate options (i.e., the rate options with the fallbacks) in legacy contracts referencing the relevant IBORs. If market participants choose to adhere to the protocol, then they would agree that their legacy derivatives contracts referencing the relevant IBORs with other adherents will include the amended and restated rate option even though they were entered into prior to the effective date of the Supplement. Such legacy derivatives contracts will therefore include the fallback provisions. Adherence to the protocol will be completely voluntary and will only amend contracts between two adhering parties (i.e., it will not amend contracts between an adhering party and a non-adhering party or between two non-adhering parties). The fallbacks included in legacy derivatives contracts by adherence to the protocol will be exactly the same as the fallbacks included in new transactions that incorporate the 2006 ISDA Definitions after the effective date of the Supplement. ISDA expects that the protocol will open for adherence when the Supplement is finalized, but about three months before the Supplement takes effect. At the end of the three-month period, the amendments made by the protocol will take effect as of the same date that the Supplement takes effect for contracts between two parties that have adhered to the protocol as of that date. If one or more counterparties to a contracts adheres to the protocol after that date, the amendments will take effect as of the date that the last counterparty adheres.

V. ISDA's Proposed Fallback Methodology Will Improve Market Stability and Efficiency

ISDA fallback rates and adjustment methodology are the result of an open, robust, and transparent consultation of market participants undertaken at the behest of international regulators in a process akin to the activities of standard setting organizations. ISDA undertook the effort to publish fallback rates at the express request of regulatory bodies and international government organizations. To develop the consultation, ISDA then utilized open-member working groups to consider the merits and drawbacks of various approaches to the fallback rates in order to ensure that all perspectives were represented. ISDA did not steer the iterative process, but instead helped working groups to collect independent comments from industry members. Through the consultation process, ISDA maintained a list of FAQs, hosted educational webinars to facilitate a transparent process and ultimately shared the detailed results of the consultation publicly on its website. As detailed further below, the proposed methodology is the product of a years-long, diligent process.

a. The Proposed Fallback Methodology Was Developed at the Behest of International Regulators

As an initial matter, ISDA engaged in work to implement more robust fallbacks for key IBORs at the behest of international regulatory bodies in order to have a procompetitive impact on derivative markets. Regulatory bodies and international governmental organizations explicitly requested that ISDA undertake this work in an attempt to stabilize the swaps and derivatives markets.[11] These regulatory bodies and international governmental organizations uniformly recognize the important competitive benefits of ISDA's reform efforts.[12]

b. The Proposed Fallback Methodology Was Developed Through a Robust, Objective, and Transparent Process

First, ISDA's Consultation process was robust. ISDA's proposed term and spread adjustments represent an approach cultivated by the diligent deliberations of market participants, regulators, and other advisors. Under ISDA's leadership, these diverse entities engaged in an open dialogue, weighing the merits of different approaches over several years.

As previously described, ISDA formed four open-membership working groups to consider fallback rates, draft amendments to the ISDA definitions, and devise a plan to amend legacy contracts that reference applicable IBORs. The working groups consisted of dealers, end users, central counterparties, and IBOR benchmark administrators. Each of the four groups focused on separate IBOR rates, although the working groups routinely conducted joint calls with each other. ISDA also created a technical group to address adoption of fallback rates by analyzing different adjustment methodologies. The working groups engaged in a comprehensive process in which participant ideas and concerns were broadly discussed and commonly agreed-upon goals were integrated into the evaluation of a

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11 Andrew Bailey, Chief Executive of the FCA, *The Future of LIBOR*, Speech at Bloomberg London, UK (July 27, 2017) https://www.fca.org.uk/news/speeches/the-future-of-libor ("Fall back language to support contract continuity or enable conversion of contracts if LIBOR ceases is an essential safety net – a 'seat belt' in case of a crash when LIBOR reaches the end of the road.")

12 *See Id.* ("For the reasons set out in the FSB's statement, [ISDA's] consultation rightly points to the overnight RFRs identified by the various Working Groups as the foundation for a fall back rate in these contracts. . . . The FSB statement reflects the collective determination of authorities across the globe.").

variety of potential approaches. In total, there were roughly 80 working group meetings attended by 93 unique participants from a broad range of institutions stretching over a ~15 month period. In the process of engaging with the FSB OSSG, ISDA circulated several "draft notes" to the various Working Groups containing the items under consideration for each meeting. These draft notes were made available to all market participants who were ISDA members, including end-users, before they were submitted to the FSB OSSG.

ISDA also engaged directly with various trade associations, including the Loan Market Association, the Association for Financial Markets in Europe, the International Capital Market Association, and the Loan Syndications and Trading Association, to obtain their perspectives as to the items under consideration. This ensured that the process included and addressed the perspectives of additional market participants. ISDA also routinely consulted with outside, independent advisors about its process, including legal counsel, The Brattle Group (economic consults), and Martin Baxter, an expert in algorithms, models and data.

Second, ISDA's process was objective. ISDA broadly engaged market participants in an extensive, iterative process to evaluate the hierarchy of fallback options. The iterative process made progressive use of inputs and comments from the meeting participants, the FSB OSSG, various regulators, trade associations, and end users, with ISDA representatives serving as a conduit amongst the Working Groups and facilitating information flows and information collection between group/subgroup meetings. ISDA did not drive the results in any particular direction, nor did it appear to ISDA that any members were trying to steer the process in any one direction. Rather, ISDA and the working groups suggested criteria to assist individual market participants in responding to the consultation based on their own independent judgment. ISDA's independent advisors have consistently reviewed, validated and tested ISDA's process through regular updates, frequent review of materials, and occasional participation in working group meetings.

Third, ISDA's process was transparent. After launching the consultation, ISDA published a consultation overview, maintained a list of FAQs on its website, and hosted two educational webinars. After publishing preliminary results on November 27, 2018,[13] ISDA shared the detailed results of the consultation publicly on December 20, 2018,[14] and plans to publish the developed approach for review and comment prior to implementation. ISDA is undertaking the same steps with respect to the current supplemental consultation for USD LIBOR, CDOR and HIBOR (and certain aspects of fallbacks for derivatives referencing SOR). ISDA has also been transparent with key regulators and government agencies. ISDA has discussed the fallbacks it will implement with numerous regulatory agencies since 2016 and has consistently provided substantive updates and materials to the FSB OSSG. During this process, ISDA has consistently updated government agencies (including the DOJ and

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13 *ISDA Publishes Preliminary Results of Benchmark Consultation*, (Nov. 27, 2018), https://www.isda.org/2018/11/27/isda-publishes-preliminary-results-of-benchmark-consultation/

14 *Anonymized Narrative Summary of Responses to the ISDA Consultation on Term Fixings and Spread Adjustment Methodologies*, (Dec. 20, 2018), https://www.isda.org/2018/12/20/isda-publishes-final-results-of-benchmark-fallback-consultation/

European Commission) of key milestones, and has attempted to preempt any potential concerns.

c. The Proposed Fallback Methodology is Implemented Contractually

ISDA's methodology will not be binding on market participants with legacy derivatives contracts referencing the relevant IBORs. There will always remain optionality with respect to how individual counter-parties choose to amend their contracts, and ISDA cannot and will not be in a position to ensure that all market participants use the fallbacks in the ISDA Definitions as a starting point for those discussions. ISDA is merely offering a fallback methodology – not a fixed price. Nevertheless, ISDA's expectation is that there will be significant adoption of the fallback methodology.

VI. Conclusion

For the foregoing reasons, ISDA respectfully requests that the Antitrust Division issue a statement that it does not presently intend to bring any enforcement action against ISDA's proposed business activities with respect to implementation of fallbacks for IBORs. We would be pleased to answer any questions or provide any additional information that may assist in your assessment of this request. Given the uncertainty regarding the timing of when IBORs may be permanently discontinued, ISDA respectfully requests that the Division provide as expeditious a response to this request for a business review letter as possible. ISDA and the FSB OSSG have discussed a strong desire to finalize the fallbacks by the end of 2019.

We also attach for your review and consideration the *Anonymized Narrative Summary of Responses to the ISDA Consultation on Term Fixings and Spread Adjustment Methodologies* report by The Brattle Group, dated December 20, 2018.

Thank you for your consideration.

Respectfully submitted,

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