

START OF A NEW TERM: ARRC RECOMMENDS CME GROUP'S TERM SOFR

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On July 29, 2021, the Alternative Reference Rates Committee (the “**ARRC**”) formally recommended the forward-looking Secured Overnight Financing Rate (“**SOFR**”) term rates (“**Term SOFR**”) developed by the CME Group (“**CME Term SOFR**”), a leading derivatives market operator.^[1] This is an important juncture in the transition from the US dollar (“**USD**”) London Interbank Offered Rate (“**LIBOR**”) to an alternative risk-free rate (“**RFR**”) because it offers market participants an RFR that works similar to LIBOR. In this bulletin, we discuss the ARRC’s announcement, the characteristics of CME Term SOFR, the types of contracts that should reference Term SOFR, and the ARRC’s conventions for Term SOFR.

1. ARRC Recommends CME Term SOFR

The ARRC’s recommendation of CME Term SOFR is a significant event, particularly for cash market participants whose preferred SOFR type^[2] is generally Term SOFR, since Term SOFR functions much like LIBOR. Notably, the total interest payable under Term SOFR is known in advance of the interest period, same as for LIBOR. This is preferred in the lending context, as borrowers are able to predict funding costs and plan their cash flow, and lenders’ back-office operations and loan conventions that are set up for LIBOR can easily make the switch to Term SOFR. Moreover, CME Term SOFR is a reflection of where the SOFR derivatives market expects SOFR rates to be at a given time, much like LIBOR is a reflection of panel bank quotes about their cost of borrowing funds. However, Term SOFR does not rely on “expert judgment”; rather, it is grounded in actual transactions and executable quotes.^[3] The recommendation of CME Term SOFR concludes the ARRC’s Paced Transition Plan from 2017 with respect to the cessation of LIBOR.^[4]

CME Term SOFR is calculated using overnight SOFR rates together with market expectations implied from SOFR-linked derivatives markets, including SOFR futures and SOFR overnight indexed swaps.^[5] As of the first half of 2021, the CME Group’s calculations were supported by US\$218 billion notional daily SOFR futures volumes transacted on its regulated electronic marketplace.^[6] CME Term SOFR is available for tenors of one, three and six-months.^[7] Additionally, the CME Group is developing a twelve-month tenor, which they expect will be available by the end of 2021.^[8] To align with the ARRC’s principles for Term SOFR, which include that Term SOFR should be limited in use (as discussed below), CME Term SOFR is available for cash market

transactions (which include business loans), derivatives that hedge cash instruments which are linked to Term SOFR, and certain securitizations that have underlying assets linked to Term SOFR.^[9] CME Group Benchmark Administration Limited is the administrator of CME Term SOFR.

The long-awaited recommendation of a Term SOFR rate is the end result of recently accelerating momentum in the area as the December 31, 2021 deadline for banks to cease issuing new USD LIBOR loans approaches. On April 20, 2021, the ARRC released key principles to guide its recommendation of Term SOFR.^[10] These key principles are that Term SOFR should: (1) meet the ARRC's criteria for alternative reference rates; (2) be rooted in a robust and sustainable base of derivatives transactions over time; and (3) have limited scope of use, to avoid usage that impacts the number of SOFR-linked derivatives transactions, since those underlying transactions are used to construct the rate itself.^[11] One day after the ARRC released its key principles, on April 21, 2021, the CME Group announced that it had developed CME Term SOFR.^[12]

Shortly thereafter, on May 6, 2021, the ARRC released a set of market indicators that would need to exist in order for it to recommend a Term SOFR rate. These indicators are: (1) continued growth in overnight SOFR-linked derivatives volumes; (2) continued deepening of SOFR derivatives liquidity; and (3) visible growth in offerings of cash products, including loans, linked to SOFR averages, either in advance or in arrears.^[13]

The ARRC's recommendation of CME Term SOFR followed soon after the announcement of the "SOFR First" initiative of the Interest Rate Benchmark Reform Subcommittee of the Commodity Futures Trading Commission's Market Risk Advisory Committee (the "**CFTC Subcommittee**"), which prioritizes trading in SOFR rather than LIBOR.^[14] On July 26, 2021, the CFTC Subcommittee's recommended market best practice requiring a switch in interdealer trading conventions from LIBOR to SOFR for USD linear interest rate swaps took effect.^[15] This resulted in increased liquidity in the SOFR derivatives market, thereby satisfying the last of the three market indicators required by the ARRC to support the recommendation of a Term SOFR rate.^[16]

2. Types of Contracts That Should Use CME Term SOFR

The ARRC has set out its best practice recommendations for the use of Term SOFR.^[17] In particular, the ARRC has made it clear that it continues to support all types of SOFR, and generally recommends that market participants use overnight SOFR and SOFR averages, due to their robustness, especially in markets that have successfully adopted these rates, including consumer products (e.g. adjustable mortgages and student loans), floating rate notes and most securitizations.^[18]

The ARRC supports the use of Term SOFR as a fallback for legacy bilateral and syndicated business loans, floating rate notes, and securitizations, consistent with its recommended fallback language for these products. It also supports the use of Term SOFR in new contracts in areas where the transition to the use of overnight SOFR and SOFR averages has been difficult, particularly in syndicated credit facilities, middle market loans and

trade finance loans. The ARRC also supports using Term SOFR for certain securitizations that hold underlying business loans or other assets that reference Term SOFR, where those assets cannot easily switch to another variation of SOFR.^[19]

The ARRC does not support the use of Term SOFR in most derivatives markets, since these markets already reference SOFR compounded in arrears, and since the transition of derivatives markets to the most robust RFRs (as opposed to Term SOFR) is needed to ensure financial stability.^[20] However, the ARRC does support the use of Term SOFR for end-user facing derivatives that hedge cash products using Term SOFR. The ARRC's position on the use of Term SOFR in derivatives markets is meant to avoid the use of Term SOFR in a way that reduces the number of transactions in the underlying derivatives markets that are needed to construct Term SOFR, in alignment with its key principles for Term SOFR.^[21]

Many credit agreements incorporate ARRC-recommended LIBOR fallback provisions with an RFR waterfall that includes Term SOFR (the definition of which includes the requirement that it is selected or recommended by the applicable governmental body) as the first step in the waterfall. Therefore, given the ARRC's formal recommendation of CME Term SOFR, at the time that the fallback provisions come into effect based on the terms of the fallback language, these credit agreements will fallback to CME's Term SOFR. New credit agreements that will use Term SOFR as the initial interest rate, and those that will be amended to incorporate Term SOFR, need to be carefully drafted with due consideration to the ARRC's conventions for Term SOFR, which are summarized below.

3. Conventions for Term SOFR

In anticipation of recommending CME Term SOFR, on July 21, 2021, the ARRC Business Loans Working Group released recommended conventions for the use of Term SOFR (as well as SOFR averages applied in advance) in syndicated and bilateral business loans.^[22] Many of the conventions are similar to those used for LIBOR.

The conventions for new Term SOFR loans include the following:^[23]

- **Reference Sources:** CME Term SOFR can be licensed from the CME Group and is available via CME DataMine, CME's Market Data Platform and data redistribution partners such as Bloomberg and Refinitiv.
- **Rate Publication and Interest Periods:** CME Term SOFR will be calculated on each day that the Federal Reserve Bank of New York calculates and publishes SOFR. As mentioned above, CME Term SOFR is available for interest periods of one, three and six-months, same as LIBOR.
- **Business Day Calendar:** The calendar referenced in credit agreements should be based on "US Government Securities Business Days", which is defined as any day except for a Saturday, Sunday or a day on which the Securities Industry and Financial Markets Association recommends that the fixed income departments of its members close for the entire day for purposes of trading in US government

securities.

- **Business Day Convention:** Payments that are scheduled to be paid on a day that is a non-business day will be made on the next business day, unless that business day falls in the next calendar month, in which case the interest payment date will be the prior business day.
- **Lookback or Interest Rate Determination Date:** Term SOFR that is published two (2) US Government Securities Business Days before the first day of the interest period should be used to set the rate for the applicable interest period, same as for LIBOR.
- **Borrowing Notices:** Notice of borrowing requests should be made three (3) US Government Securities Business Days prior to the borrowing date, same as for LIBOR.
- **Day-count:** The recommended day-count is actual/360 days, but it is possible to use other day-counts (e.g. actual/365 days).
- **Funding Losses:** Language regarding funding losses may be inserted into credit agreements, such as losses due to intra-period prepayments or conversions.
- **Interest Rate Floors:** Any interest rate floor should apply to Term SOFR.
- **Rounding:** Term SOFR is calculated to five decimal places and dollar amounts can be calculated to two decimal places, same as for LIBOR.
- **Temporary Unavailability:** Credit agreements should include a temporary fallback convention if Term SOFR is not published for a short period of time, similar to LIBOR.
- **Fallback Language:** Credit agreements should include robust fallback language, such as the ARRC's recommended fallback language for syndicated and bilateral business loans.

Most of the above conventions would apply to legacy LIBOR loans that fallback to Term SOFR. In addition, in such legacy credit agreements, a spread adjustment would be applied to Term SOFR, and any interest rate floor would apply to the sum of Term SOFR plus the applicable spread adjustment.^[24] The conventions are voluntary.

4. Conclusion

Cash market participants who have been eagerly awaiting the development of Term SOFR, due to its similarities to LIBOR, will welcome the ARRC's recommendation of CME Term SOFR. Indeed, the ARRC's recommendation of a Term SOFR rate is a key stepping-stone in the transition away from USD LIBOR. Lenders and borrowers can now accelerate this transition by becoming familiar with CME Term SOFR and how it can be used in their loan documents.

We will continue to monitor progress with respect to the cessation of LIBOR and will provide updates as notable milestones occur.

[1] Alternative Reference Rates Committee, “[ARRC Formally Recommends Term SOFR](#)” (29 July 2021). [Term SOFR Recommended].

[2] For additional information about the different types of SOFR, please see our July 2021 bulletin, [SOFR Fundamentals: What We Know SO-FAR](#).

[3] CME Group, “[CME Term SOFR Reference Rates](#)” (Accessed 3 September 2021).

[4] *Supra*, note 1 [Term SOFR Recommended]; see also Alternative Reference Rates Committee, “[Transition from LIBOR](#)” (Accessed 3 September 2021).

[5] *Supra*, note 3; CME Group, “[CME Group Announces Launch of CME Term SOFR Reference Rates](#)”, (21 April 2021), [CME Announcement]; CME Group, “[CME Term SOFR Reference Rates Benchmark Methodology](#)” (21 April 2021).

[6] CME Group, “[CME Term SOFR Reference Rates, FAQ](#)” (30 July 2021).

[7] *Supra*, note 5 [CME Announcement].

[8] *Supra*, note 6.

[9] *Supra*, note 6.

[10] *Supra*, note 1.

[11] Alternative Reference Rates Committee, “[Key Principles to Guide the ARRC as it Considers the Conditions in Believes are Necessary to Recommend a Forward-Looking SOFR Term Rate](#)” (20 April 2021).

[12] *Supra*, note 5 [CME Announcement].

[13] Alternative Reference Rates Committee, “[ARRC Identifies Market Indicators to Support a Recommendation for a Forward-Looking SOFR Term Rate](#)” (6 May 2021).

[14] Alternative Reference Rates Committee, “[ARRC Welcomes MRAC Subcommittee’s Recommended Dates for Transitioning Interdealer Swap Market Trading Conventions to SOFR](#)” (9 June 2021) [ARRC Welcomes MRAC]. See also Commodity Futures Trading Commission, “[CFTC’s Interest Rate Benchmark Reform Subcommittee Recommends July 26 for Transitioning Interdealer Swap Market Trading Conventions from LIBOR to SOFR](#)” (8 June 2021) and Commodity Futures Trading Commission, “[CFTC Market Risk Advisory Committee Adopts SOFR First Recommendation at Public Meeting](#)” (13 July 2021).

[15] *Ibid.*, ARRC Welcomes MRAC.

[16] *Ibid.*, ARRC Welcomes MRAC.

[17] See Alternative Reference Rates Committee, “[ARRC Best Practice Recommendations Related to Scope of Use of the Term Rate](#)” (21 July 2021, as updated 27 August 2021).

[18] *Ibid.*

[19] *Ibid.*

[20] *Ibid.*

[21] *Ibid.*

[22] Alternative Reference Rates Committee, “[Forward Looking Term SOFR and SOFR Averages \(Applied in Advance\) Conventions for Syndicated and Bilateral Business Loans](#)” (21 July 2021).

[23] *Ibid.*

[24] *Ibid.*

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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