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Alert

SEC Staff Publishes Statement on LIBOR Transition

July 18, 2019

On July 12, 2019, the staffs of several divisions ("Staff") within the SEC published a statement ("Statement") on the transition away from the London Interbank Offered Rate ("LIBOR").[1] The panel banks which currently report information used to establish LIBOR for different currencies have committed to do so through 2021. After 2021, it is likely that LIBOR will cease to be reported, and, even if it is reported after 2021, it may no longer be a viable representation of interbank borrowing costs for the applicable tenors. In a July 15, 2019 speech, Andrew Bailey, chief executive of LIBOR's regulator, the Financial Conduct Authority of the United Kingdom, stated that the "base case" assumption for firms' planning should be no publication of LIBOR after the end of 2021.[2]

Groups in the United States and other nations are working on replacements to LIBOR in order to avoid market disruptions. In the United States, the Alternative Reference Rates Committee ("ARRC") convened by the Federal Reserve Board and the Federal Reserve Bank of New York has identified the Secured Overnight Financing Rate ("SOFR") as its preferred replacement for U.S. Dollar LIBOR.[3]

In the Statement, the Staff does not endorse the use of any particular reference rate but encourages market participants to begin managing their transition away from LIBOR and, for existing LIBOR-based transactions, to consider the following as they seek to analyze and mitigate the risks related to the transition from LIBOR:

- Do you have, or are you or your customers exposed to, any contracts extending past 2021 that reference LIBOR? For companies considering disclosure obligations and risk management policies, are these contracts, individually or in the aggregate, material?
- For each contract identified, what effect will the discontinuation of LIBOR have on the operation of the contract?
- For contracts with no fallback language in the event LIBOR is unavailable, or with fallback language that does not contemplate the permanent discontinuation of LIBOR, do you need to take actions to mitigate risk, such as proactive renegotiation with counterparties to address the contractual uncertainty?
- What alternative reference rate (for example, SOFR) might replace LIBOR in existing contracts? Are there fundamental differences between the methods of calculation of LIBOR and the

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[1] The Statement, which can be found at https://www.sec.gov/news/public-statement/libor-transition#_ftn1, notes that it is not a rule, regulation or statement of the SEC (and does not affect current applicable law or create new or additional obligations) but a statement reflecting the views of the respective staffs of the Divisions of Corporation Finance, Investment Management, Trading and Markets and the Office of the Chief Accountant.

[2] See https://www.fca.org.uk/news/speeches/libor-preparing-end.

[3] For more information, see https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/ARRC-faq.pdf.

alternative reference rate that could impact your profitability or costs? Does the alternative reference rate need to be adjusted (by the addition of a spread, for example) to maintain the anticipated economic terms of existing contracts?

- For derivative contracts referencing LIBOR that are utilized to hedge floating rate investments or obligations, what effect will the discontinuation of LIBOR have on the company's hedging strategy?
- Does use of an alternative reference rate introduce new risks that need to be addressed? For example, if you have relied on LIBOR in pricing assets as a natural hedge against increases in costs of capital or funding, will the replacement rate behave similarly? If not, what actions should be taken to mitigate this new risk?

In addition, the Statement includes suggestions relating to new contracts and other business risks:

- Market participants should also consider whether contracts entered into in the future should reference an alternative rate to LIBOR (such as SOFR) or, if such contracts reference LIBOR, include effective fallback language.
- Market participants should identify, evaluate and mitigate other consequences of the discontinuation of LIBOR on their business, such as on strategy, products, processes and information systems.

The Division of Corporation Finance stated that it is important to keep investors informed about the progress toward risk identification and mitigation and, in deciding which disclosures are relevant and appropriate, to consider the following guidance:

- The evaluation and mitigation of risks related to the expected discontinuation of LIBOR may span several reporting periods. Consider disclosing the status of company efforts to date and significant matters yet to be addressed.
- When a company has identified a material exposure to LIBOR but does not yet know or cannot yet reasonably estimate the expected impact, consider disclosing that fact.
- Disclosures that allow investors to see this issue through the eyes of management are likely to be the most useful for investors. This may entail sharing information used by management and the board in assessing and monitoring how transitioning from LIBOR to an alternative reference rate may affect the company. This could include qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR and extending past 2021.

The Division of Investment Management is actively monitoring the impact of the expected discontinuation of LIBOR on investment companies ("funds") and advisers, noting that:

- For those funds that invest in instruments referencing LIBOR, the discontinuation of LIBOR may impact the functioning, liquidity and value of their investments.
- Funds should consider assessing the impact on the liquidity of their investments, including how those investments are classified and, for registered funds, whether this could affect their

liquidity risk management programs, to ensure compliance with Rule 22e-4 under the Investment Company Act of 1940.

- Even funds that do not hold investments linked to LIBOR could be impacted if they have other contracts which reference LIBOR and extend beyond 2021.
- In addition, funds that have received exemptive orders that reference LIBOR (such as interfund lending orders) should consider evaluating possible implications for terms and conditions of their relief.
- Funds and advisers should consider whether the impacts discussed above, and other consequences of the discontinuation of LIBOR, are risks that they should disclose to investors. Whether disclosure is appropriate, and the content of such disclosure, will depend on the nature and significance of the investments or agreements that are linked to LIBOR.
- For the instruments extending past 2021 which reference LIBOR, advisers should consider the effect of the discontinuation of LIBOR when recommending them to clients or monitoring them for clients.

The Division of Trading and Markets is actively monitoring the impact that the discontinuation of LIBOR will have on broker-dealers, central counterparties and exchanges, as these entities may be parties to transactions or hedges that reference LIBOR, issue instruments or own investments that reference LIBOR, underwrite, place or recommend securities or instruments that reference LIBOR or have listing and clearing standards that do not contemplate replacement benchmarks. The Statement encourages these entities to analyze how this change will impact them, and whether their clients and markets should be informed of the risks related to this change.

Lastly, the Office of the Chief Accountant is actively monitoring the activities underway among preparers and auditors of financial statements, standard setters such as the Financial Accounting Standards Board and other regulators to address financial reporting issues that might arise in connection with any transition from LIBOR to an alternative benchmark rate. These issues could span a number of different areas, including, for example, the accounting and financial reporting for modifications of terms of debt instruments, hedging activities, inputs used in valuation models and potential income tax consequences.

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If you have any questions concerning this *Alert* or the LIBOR transition, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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