

July 18, 2019

SEC Issues Statement Highlighting Risks Regarding LIBOR Transition

On July 12, the SEC's staff issued a statement (the "LIBOR Statement") urging market participants to prepare for the transition away from the London Interbank Offered Rate ("LIBOR") reference rate.¹ The LIBOR Statement represents the views of the Divisions of Corporation Finance, Investment Management and Trading and Markets, as well as the Office of the Chief Accountant. The SEC staff highlighted several areas for particular attention during this transition process.² This announcement echoes those made by other regulators and financial industry participants that the transition from LIBOR to alternative reference rates ("ARRs") must be a focus well before LIBOR ceases publication, which is expected to occur in 2021. The SEC staff described the transition from LIBOR as "taking on urgency," and market participants should take steps now to account for LIBOR's expected discontinuation.³

Background

LIBOR is a benchmark interest rate at which large banks indicate that they can borrow short-term wholesale funds on an unsecured basis in the interbank market.⁴ LIBOR is published daily in five currencies and seven tenors, and represents the average of submissions from panel banks, resulting in the daily publication of 35 interest rates by the Intercontinental Exchange.⁵ LIBOR is widely used as a benchmark rate (or reference rate) in a variety of commercial and financial contracts, including but not limited to bonds, interest rate swaps and other derivatives, loans, floating rate mortgages and student loans.⁶ It is estimated that financial contracts reference \$200 trillion in notional value in USD LIBOR, with over \$35 trillion referenced in contracts extending past 2021.⁷

In 2017, the U.K. Financial Conduct Authority announced that all of the panel banks that submit LIBOR had agreed to continue to do so until the end of 2021, at which point it is expected that a transition will be made from LIBOR to ARRs.⁸ A few days ago, the head of the Financial Conduct Authority ("FCA") reiterated that market participants' base case assumption should be that LIBOR will not be published after the end of 2021 and, even if some banks continue to publish LIBOR, there is "a high probability that it will no longer pass regulatory tests of representativeness."⁹

The expected cessation of LIBOR's publication presents unique challenges to financial institutions and other market participants. One of the key questions market participants face is deciding which ARR (or ARRs) will replace LIBOR in LIBOR-referencing contracts. 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 “the rate that represents best practices for use in certain new USD derivatives and other financial contracts.”¹⁰

SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities in the repurchase, or “repo,” market.¹¹ Among other differences from LIBOR, SOFR (1) is considered a “near risk-free rate” (*i.e.*, it lacks a credit risk component) because it is secured by U.S. Treasuries; and (2) lacks a forward-looking component such as LIBOR’s one-week and one-, two-, three-, six- and twelve-month tenors.¹²

In the July 12 press release accompanying the LIBOR Statement, SEC Chairman Jay Clayton said unambiguously:

[T]he discontinuation of LIBOR could have a significant impact on financial markets and may present a material risk for market participants, including public companies, investment advisers, investment companies, and broker-dealers. These risks will be exacerbated if the work necessary to effect an orderly transition to an alternative reference rate is not completed in a timely manner.¹³

Chairman Clayton’s identification of potential risks associated with the transition from LIBOR comports with the SEC’s prior pronouncements and those issued by other financial regulators.¹⁴

The LIBOR Statement

The LIBOR Statement addresses three areas that market participants should focus on to manage the transition from LIBOR.

- 1. Existing Contracts.** The SEC encouraged market participants, to the extent they have not done so already, to commence the process of identifying contracts that extend beyond 2021 to determine their exposure to LIBOR. In particular, the SEC noted that many legacy contracts referencing LIBOR were drafted at a time when the drafters “did not contemplate the permanent discontinuation of LIBOR and, as a result, there may be uncertainty or disagreement over how the contracts should be interpreted.”¹⁵
- 2. New Contracts.** When entering into new contracts that would normally reference LIBOR, the SEC advises market participants to consider whether to instead reference an ARR, or if the decision is made to reference LIBOR, whether to include effective fallback language to account for the cessation of LIBOR’s publication.¹⁶ The ARRC has issued recommended fallback language for new issuances of floating rate notes, syndicated loans, bilateral business loans, and securitizations.¹⁷ Market participants should monitor publications by the International Swaps and Derivatives Association for fallback language for swaps and derivatives.

- 3. Other Business Risks.** The SEC staff encouraged market participants to assess the impact, if any, that the discontinuation of LIBOR will have on existing and new contracts, and to implement mitigations efforts.¹⁸ Particular emphasis should be placed on information technology systems, namely to ensure that they are capable of incorporating new ARR with features that differ from LIBOR.¹⁹ Depending on their exposure to LIBOR, market participants may wish to create company-specific task forces to address the impact of financial, legal, and regulatory risks arising from the LIBOR transition.²⁰

Additionally, each of the Divisions of Corporation Finance, Investment Management and Trading and Markets, and the Office of the Chief Accountant provided guidance to registrants and other market participants likely to be impacted by the discontinuation of LIBOR. The guidance is tailored to the different constituencies regulated by the SEC, each group facing potentially different challenges. For example:

- The Division of Corporation Finance staff recommended that registrants, in the context of their public disclosure requirements, keep investors informed about their progress towards risk identification and mitigation and any anticipated material impact on the registrant.²¹
- The Division of Investment Management staff advised investment companies and advisers to, among other things, consider providing investors with tailored risk disclosures describing with specificity the impact of the transition on the investors' holdings and advisers' recommendations for instruments that reference LIBOR beyond 2021.²² Such companies and advisers are encouraged to assess any impact of the discontinuation of LIBOR on the liquidity of their fund investments, including how those investments are classified and whether the transition could alter the effectiveness of liquidity risk management programs.
- The Division of Trading and Markets staff encouraged broker-dealers, central counterparties, and exchanges to analyze how LIBOR cessation might impact them and whether disclosures should be made to clients and markets.²³
- The Office of the Chief Accountant staff noted that the transition from one benchmark to another may have a significant impact on accounting and financial reporting.²⁴ The potential accounting considerations could affect a number of different areas, including, for example, the accounting and financial reporting for modifications of terms within debt instruments, hedging activities, inputs used in valuation models and potential income tax consequences.

Significance and Takeaways

While many aspects of the transition away from LIBOR will cause operational, business, and legal difficulties, several of the questions posed by the SEC for consideration with regard to existing contracts highlight particular challenges faced by market participants as they prepare for LIBOR cessation:

- What alternative reference rate (for example, SOFR) might replace LIBOR in existing contracts? Are there fundamental differences between LIBOR and the alternative reference rate – such as the extent of or absence of counterparty credit risk – that could impact the profitability or costs associated with the identified contracts? 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 derivatives contracts referencing a LIBOR-based interest rate of a floating-rate investment or obligation they are utilized to hedge, what effect will the discontinuation of LIBOR and the transition to an ARR in the underlying investment or obligation have on the effectiveness of the 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 new rate behave similarly? If not, what actions should be taken to mitigate this potential risk?²⁵

The answers to these questions are by no means clear. Because LIBOR is an unsecured lending rate that incorporates credit risk, while SOFR is a secured lending rate that incorporates little to no credit risk, SOFR is likely to be lower than LIBOR. Similarly, longer tenors on LIBOR reference rates compared to the strictly overnight nature of SOFR likely would introduce differences in the rates due to different maturities. By way of example, if a contract referenced USD LIBOR with a three-month maturity plus a certain number of basis points as margin, merely substituting “SOFR” for “USD Three Month LIBOR” likely will result in an unintended “value transfer.” Accordingly, market participants are expected to apply a spread to SOFR to reflect differences in credit risk and tenor expressed in the two rates with the goal of promoting a greater degree of equivalence between the two reference rates. There remains significant uncertainty regarding how this spread adjustment will be determined, whether it will be dynamic or fixed, and whether there will be industry and regulator consensus on its calculation. We understand that ARRC plans to issue a market consultation relating to spread adjustments for comment later this year.²⁶

With respect to any ARR(s) that might replace LIBOR, the rate(s) ultimately selected may very well change the economic relationships between counterparties and impact financial reporting, including the valuation of assets and liabilities. Floating rate contracts may switch to fixed rates. Contracts referencing one-week, one-, two- or three-month or longer LIBOR tenors may switch to SOFR, an overnight rate with no present

equivalent of forward-looking term rates. An ARR may perform inversely to LIBOR during periods of market uncertainty (*e.g.*, ARRs go down instead of up), potentially requiring a reassessment of hedging strategies premised on LIBOR-referencing instruments. Hedging agreements may need to be renegotiated to continue to perform as intended. Another risk market participants may wish to consider is the likelihood that contracts in different jurisdictions will reference different ARRs, and how to account for those on an enterprise-wide basis.

Such changes may be material, and as market participants consider LIBOR cessation, they may wish to consider whether to issue new risk disclosures or update existing disclosures to account for potential risks arising from the transition from LIBOR to ARRs. As market participants work to better understand these issues, develop LIBOR transition proposals, and implement transition protocols pursuant to the directives of regulators, there may (and likely will) be a need to interact with other market participants in order to ensure an orderly transition to ARRs. Such interactions should be limited to responding to the legitimate (and mandated) directives of regulators and should be undertaken in light of all obligations under relevant laws and regulations, including antitrust.

As the SEC observed in its statement: “For many market participants, waiting until all open questions have been answered to begin this important work likely could prove to be too late to accomplish the challenging task required.”²⁷ Regulators are indicating LIBOR’s publication is likely to cease, and market participants should expect that LIBOR will not be published beyond 2021.

Market participants should continue to stay apprised of these issues through ongoing discussions with regulators, monitoring regulatory developments from their regulators and working groups such as ARRC, and consultations with outside counsel on industry-wide efforts to address these, and other, challenging questions.

We will continue to monitor LIBOR transition developments and look forward to providing you with further updates.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman
+44-20-7367-1601

mbergman@paulweiss.com

Joseph J. Bial
+1-202-223-7318

jbial@paulweiss.com

Susanna M. Buerger
+1-212-373-3553

sbuerger@paulweiss.com

Manuel S. Frey
+1-212-373-3127

mfrey@paulweiss.com

Kenneth A. Gallo
+1-202-223-7356

kgallo@paulweiss.com

Brad S. Karp
+1-212-373-3316

bkarp@paulweiss.com

Jane B. O'Brien
+1-202-223-7327

jobrien@paulweiss.com

Richard A. Rosen
+1-212-373-3305

rrosen@paulweiss.com

Charles F. "Rick" Rule
+1-202-223-7320

rrule@paulweiss.com

Associates Teresa Akkara, Alexandra Gordon, and Anand Sithian and Securities Practice Management Attorney Monika G. Kislowska contributed to this client alert.

¹ *Staff Statement on LIBOR Transition*, U.S. Securities and Exchange Commission (July 12, 2019), available [here](#) (last visited July 14, 2019).

² *Id.*

³ *Id.*

⁴ *LIBOR*, ICE Benchmark Administration, available [here](#) (last visited July 14, 2019).

⁵ *Id.* LIBOR rates are presently calculated by using a trimmed arithmetic mean. *Calculating*, ICE Benchmark Administration, available [here](#) (last visited July 14, 2019). Each submission is ranked in descending order and then the highest and lowest 25% of submissions are excluded. This trimming methodology excludes outliers from the final calculation. *Id.*

⁶ *Staff Statement*, *supra* n.1.

⁷ *The Second Report of the Alternative Reference Rates Committee*, Federal Reserve Bank of New York, 12 (Mar. 2018), available [here](#) (last visited July 14, 2019); *Staff Statement*, *supra* n.1, at n.4.

⁸ *FCA Statement on LIBOR panels*, Financial Conduct Authority (Nov. 24, 2017), available [here](#) (last visited July 14, 2019).

⁹ Speech, Andrew Bailey, Chief Executive of the FCA, LIBOR: Preparing for the End (July 15, 2019), available [here](#).

¹⁰ *The Alternative Reference Rates Committee: Transition from LIBOR*, Federal Reserve Bank of New York, available [here](#) (last visited July 14, 2019). While SOFR is anticipated to be the USD LIBOR ARR in the United States, other jurisdictions plan on publishing their own ARRs, including the United Kingdom (Sterling Overnight Rate, or SONIA), the Eurozone area (Euro Short-Term Rate, or ESTER), Switzerland (Swiss Average Overnight Rate, or SARON), and Japan (Tokyo Overnight Average Rate, or TONA).

-
- ¹¹ Michael Held, *SOFR and the Transition from LIBOR*, Bank for International Settlements (Mar. 18, 2019) available [here](#) (last visited July 14, 2019).
- ¹² *Id.*
- ¹³ Press Release, U.S. Securities and Exchange Commission, SEC Publishes Statement Highlighting Risks for Market Participants to Consider As They Transition Away From LIBOR (July 12, 2019) available [here](#) (last visited July 14, 2019).
- ¹⁴ For example, earlier this year, the Executive Vice President of the Legal Group of the Federal Reserve Bank of New York stated the following about the transition from LIBOR: “The task is immense. But it is not insurmountable. Much work has been accomplished, and much work remains. Every firm that has exposure to LIBOR needs to prepare now for the risk—indeed, the likelihood—that LIBOR will cease in the near future.” Held, *supra* n.11.
- ¹⁵ *Staff Statement, supra* n.1.
- ¹⁶ *Id.* Generally speaking, “fallback” contractual language refers to, among other things, who will select the ARR, how will it be selected, when will it be effective, whether a spread will be necessary to account for economic differences between the ARR and LIBOR, and how that spread will be calculated.
- ¹⁷ *Id.*
- ¹⁸ *Id.*
- ¹⁹ *Id.*
- ²⁰ *Id.*
- ²¹ *Id.*
- ²² *Id.* In particular, the SEC staff encourages registrants to consider the following guidance when preparing their disclosures: (a) when evaluating and mitigating risks related to the expected discontinuation of LIBOR, consider disclosing the status of the registrant’s efforts to date and the significant matters yet to be addressed; (b) when a registrant has identified a material exposure to LIBOR but does not yet know or cannot yet reasonably estimate the expected impact, consider disclosing that fact; and (c) consider sharing with investors information used by the registrant’s management and the board in assessing and monitoring how transitioning from LIBOR to an alternative reference rate may affect the registrant (which could include qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR and extending beyond 2021).
- ²³ *Id.*
- ²⁴ *Id.*
- ²⁵ *Id.*
- ²⁶ Although ARRC has issued recommended fallback contract language for adjustable rate mortgages, bilateral business loans, floating rate notes, securitizations, and syndicated loans that include references to spread adjustments, these recommendations do not actually specify the calculation of any spread adjustments. “Fallback Contract Language,” ARRC, available [here](#) (last visited July 17, 2019).
- ²⁷ *Id.*