

SEC Staff Publishes Statement on Risks of Transition Away from LIBOR

As a continuation of our previous update on the phase-out of the London Interbank Overnight Rate (“LIBOR”) ([April 30, 2019: What the LIBOR Phase-out Means for Debt Capital Market Participants](#)), the Securities and Exchange Commission (the “SEC”) announced on July 12, 2019, that it published a statement encouraging market participants to proactively manage their transition away from LIBOR and outlined several potential areas that may warrant increased attention during that time. It is expected that parties reporting information used to set LIBOR will stop doing so after 2021.

The Issue

As LIBOR is used extensively in the United States and globally as a benchmark rate to set interest rates for various commercial and financial contracts, the 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.

The staff statement encourages market participants to identify existing contracts that extend past 2021 to determine their exposure to LIBOR and to consider whether contracts entered into in the future should reference an alternative rate to LIBOR or include effective fallback language. The statement also contains specific guidance for how registrants might respond to risks associated with the discontinuation of LIBOR.

Alternative Reference Rates

Working groups have been formed in each of the United States, the United Kingdom, the European Union, Japan, and Switzerland to recommend an alternative rate to LIBOR for its respective currency. In the United States, the Alternative Reference Rates Committee (“ARRC”), a group convened by the Federal Reserve Board and the Federal Reserve Bank of New York, is comprised of a diverse set of private-sector entities, each with an

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important presence in markets affected by USD LIBOR, and a wide array of official-sector entities, including the SEC, banking regulators, and other financial sector regulators, as non-voting ex-officio members. The ARRC has identified the Secured Overnight Financing Rate (“SOFR”) as its preferred alternative rate for USD LIBOR. SOFR is a measure of the cost of borrowing cash overnight, collateralized by U.S. Treasury securities, and is based on directly observable U.S. Treasury-backed repurchase transactions. This is a liquid market with daily volumes regularly in excess of \$800 billion. Some market participants are also considering other USD reference rates for certain instruments.

Managing the Transition from LIBOR

Existing Contracts

The SEC staff is encouraging market participants who have not already done so to begin the process of identifying existing contracts that extend past 2021 to determine their exposure to LIBOR. Many legacy contracts have interest rate provisions referencing LIBOR that, when drafted, 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. In addition, in circumstances where the contractual interpretation is clear, the adjustment may be inconsistent with expectations of the affected parties. In certain cases, for example, a floating rate obligation may become a fixed rate obligation. There are rarely quick fixes to these types of issues, and the SEC staff is encouraging market participants to focus on them now to avoid business and market disruptions after 2021. In particular, the SEC staff is encouraging market participants to consider questions along the lines of the following as they seek to understand 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 expected permanent discontinuation of LIBOR, do you need to take actions to mitigate risk, such as proactive renegotiations 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 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?

New Contracts

Market participants also should 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. The ARRC has published recommended fallback language for new issuances of floating rate notes, syndicated

loans, bilateral business loans, and securitizations. The ARRC's recommended fallback language seeks to provide interest rate provisions that will function upon the expected discontinuation of USD LIBOR and promotes general consistency in defining key terms such as benchmark transition events, benchmark replacement, and benchmark replacement adjustments.

In addition, the International Swaps and Derivatives Association ("ISDA"), which maintains industry standard swaps and derivatives documentation, has been leading an industry effort to implement robust fallback language for derivatives contracts since 2016, at the request of the Financial Stability Board's Official Sector Steering Group. Fallback language that ISDA is currently developing with industry feedback will apply to derivatives entered into on ISDA documentation after the date of adoption. Additionally, if counterparties consent per a standard protocol, this fallback language will be applied to outstanding obligations of consenting counterparties.

Disclosure Recommendations by the Division of Corporate Finance

As companies consider the issues in relation to the transition from LIBOR and address the risks presented by LIBOR's expected discontinuation, it is important to keep investors informed about the progress toward risk identification and mitigation, and the anticipated impact on the company, if material. In deciding what disclosures are relevant and appropriate, the Division of Corporate finance at the SEC is encouraging companies 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 the 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.

At this stage in the transition away from LIBOR, the SEC noted that companies most frequently providing LIBOR transition disclosure are in the real estate, banking, and insurance industries. The SEC also noted that, based on their reviews to date, the larger the company, the more likely it is to disclose risks related to LIBOR's expected discontinuation. However, for every contract held by one of these companies providing disclosure, there is a counterparty that may not yet be aware of the risks it faces or the actions needed to mitigate those risks. The SEC is therefore encouraging every company, if it has not already done so, to begin planning for this important transition.

For the full version of the SEC statement, see [Staff Statement on LIBOR Transition](#).

