HUNTON ANDREWS KURTH

Client Alert

July 2019

SEC Warns of Risks Related to LIBOR Transition

On July 12, 2019, the staffs of the Division of Corporation Finance, the Division of Investment Management, the Division of Trading and Markets and the Office of the Chief Accountant of the Securities and Exchange Commission (the “Staffs”) issued a joint statement (the “LIBOR Statement”) highlighting certain risks for market participants related to the upcoming transition away from the London Interbank Offered Rate (“LIBOR”). The LIBOR Statement notes that a number of private-sector banks that currently report information used to set LIBOR will stop doing so after 2021 when their current reporting commitment ends. This discontinuation could either cause LIBOR to stop being published immediately or could cause LIBOR’s regulator to determine that its quality has degraded to such a level that it is no longer representative of the underlying market. Accordingly, the Staffs have identified several potential areas that warrant increased attention in this period leading up to the 2021 transition.

For further information on the LIBOR transition, see our August 2017 client alert entitled “The End of LIBOR” and our May 2019 client alert entitled “ARRC Releases Recommended LIBOR Fallback Language.”

Managing the Transition from LIBOR

- Existing Contracts. Market participants should identify existing contracts that extend past 2021 to determine their exposure to the LIBOR transition. The Staffs warn that many legacy contracts have interest rate provisions that reference LIBOR and such provisions do not contemplate the permanent discontinuation of LIBOR. As a result, there may be uncertainty or disagreement over how the contract should be interpreted after 2021.

  Specifically, the Staffs encourage market participants to consider the following questions as they seek to understand and mitigate their risks related to the LIBOR transition:

  - Does the market participant have or do its customers have exposure to any material contracts extending past 2021 that reference LIBOR?
  - For each contract identified, what effect will the discontinuation of LIBOR have on the operation of the contract?
  - What actions can the market participant take to mitigate such risk (e.g., proactively renegotiate with counterparties to address the contractual uncertainties)?
  - What alternative reference rate might replace LIBOR in existing contracts? The Staffs note that the Alternative Reference Rates Committee (“ARRC”), a group convened by the Federal Reserve Board and the Federal Reserve Bank of New York to identify and recommend an alternative rate to U.S. Dollar LIBOR, has identified the Secured Overnight Financing Rate (“SOFR”) as its preferred alternative rate to U.S. Dollar LIBOR. SORF 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.

- To the extent derivative contracts used to hedge floating-rate investments reference LIBOR, what effect will the discontinuation of LIBOR have on these hedging strategies?

- Does the use of an alternative reference rate introduce new risks that need to be addressed?

- New Contracts. The Staffs also recommend that market participants consider referencing an alternative rate to LIBOR (such as SOFR) in new contracts. Alternatively, market participants should consider including fallback language regarding the reference rate to be used if, or when, LIBOR becomes unavailable. As noted above and discussed in our prior client alert, the ARRC has published recommended fallback language for new issuances of floating rate notes, syndicated loans, bilateral business loans, and securitizations.

- Other Business Risks. The Staffs encourage market participants to also identify, evaluate, and mitigate other potential consequences associated with the discontinuation of LIBOR that may adversely affect their business (e.g., ensure their information technology systems are able to incorporate new instruments and rates with features other than LIBOR).

In addition to the general guidance provided by the Staffs, the LIBOR Statement included division-specific guidance tailored to the different constituencies regulated by the Division of Corporation Finance, the Division of Investment Management, the Division of Trading and Markets, and the Office of the Chief Accountant.

- Division of Corporation Finance. The Division of Corporation Finance notes that existing federal securities laws – including rules and regulations related to disclosure of risk factors, management's discussion and analysis, board risk oversight, and financial statements – require timely, comprehensive, and accurate disclosure of risks and events that a reasonable investor would consider important to an investment decision (i.e., material). If companies consider the risks presented by the LIBOR transition to be material, they must keep investors informed of the progress toward risk identification and mitigation, and the anticipated impact on the company. In deciding what disclosures are relevant and appropriate, the Division of Corporation Finance encourages companies to consider the following information:

  - the status of a company's efforts to date and the significant matters yet to be addressed concerning the discontinuation of LIBOR—keeping in mind that this process may span several reporting periods;

  - any identified material exposures to the LIBOR transition, even if a company cannot yet reasonably estimate the expected impact; and

  - the information used by management and the board in assessing and monitoring how transitioning from LIBOR to an alternative reference rate may affect the company, as this information may be the most useful to investors.

  The Division of Corporate Finance notes that real estate, banking and insurance companies are currently the most frequent providers of LIBOR transition risk disclosures, but reminds registrants that every company, regardless of its industry, should plan for (and keep investors informed of) the LIBOR transition.

- Division of Investment Management. The Division of Investment Management is actively monitoring the impact of the LIBOR transition on investment companies and advisers, particularly those that invest in instruments referencing LIBOR, such as floating rate debt, bank loans, LIBOR-linked derivatives, and certain asset-backed securities. It warns that the discontinuation of LIBOR may affect the functioning, liquidity, and value of these investments. By way of example, investments without fallback language, or with fallback language that does not contemplate the discontinuation of LIBOR, may become less liquid and/or change in value as the 2021 transition deadline approaches.

The Division of Investment Management notes that funds should also assess the impact of the LIBOR transition and consider whether it should be disclosed to investors. The Division of Investment Management encourages affected funds to tailor their risk disclosures to specifically describe the impact of the transition on their holders (as opposed to providing a generic disclosure that the division believes is less helpful to investors).

- Division of Trading and Markets. Broker-dealers, central counterparties, and exchanges are encouraged to analyze how the LIBOR transition will impact their business, systems, models, process, risk management frameworks, and clients. Specifically, the Division of Trading and Markets notes that these entities underwrite and/or make markets in instruments referencing LIBOR or recommend LIBOR-based securities, including to retail investors.

- Office of the Chief Accountant. The Office of the Chief Accountant notes that an interest rate benchmark can have a pervasive impact on a company's financial reporting, and transitioning from one benchmark rate to another benchmark rate can have a significant impact on a company's accounting. These issues span a number of different areas, including the accounting and financial reporting for debt instruments, hedging activities, inputs used in valuation models, and potential income tax consequences.

  The Office of the Chief Accountant encourages preparers, auditors, and regulators to consult with the Office of the Chief Accountant to discuss and analyze questions in this area prior to filing. Furthermore, constituents are encouraged to participate in the standard-setting process by both the Financial Accounting Standards Board and the International Accounting Standards Board.

Takeaways

The LIBOR Statement serves as a reminder that the process to identify, analyze, and mitigate risks associated with the expected discontinuation of LIBOR will take time; therefore, market participants should act now. Furthermore, it is unlikely that market participants will simply be able to substitute "SOFR" (or some other alternative rate) for "LIBOR" in its existing and future contracts for the following reasons:

- LIBOR is an unsecured lending rate that therefore incorporates credit risk; whereas, SOFR is a secured lending rate that therefore does not incorporate credit risk. As a result, SOFR is likely to be lower than LIBOR. To account for this fact, market participants will need to apply a spread to SOFR to reflect the credit risk difference. While the ARRC plans to issue a market consultation relating to this spread adjustment for comment later this year, there remains uncertainty regarding the form this spread will take and to what degree it will be accepted by all market participants.

- Many existing contracts reference various LIBOR tenors (e.g., one-month LIBOR or three-month LIBOR); however, SOFR is an overnight rate with no current equivalent for such forward-looking rates.

- While LIBOR is largely used across the globe, it is yet to be seen if SOFR or a different alternative rate will be widely accepted. There is a possibility that different jurisdictions use different alternative rates, which would make re-negotiations of existing cross-border contracts difficult, potentially hamper future negotiations, and in some situations cause market participants to reconsider their existing hedging positions.

These changes (or potential changes) may be material to various market participants. As a result, they should consider whether new or updated disclosures are required to describe these risk.

We will continue to monitor developments concerning the transition away from LIBOR and are ready to assist as market participants work through this process.

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