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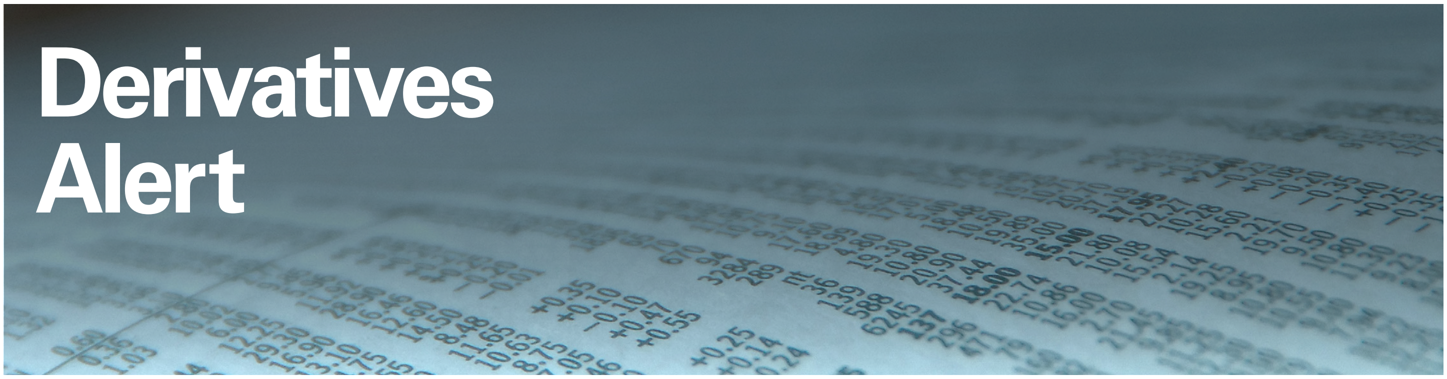
Skadden

Derivatives Alert



If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

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ISDA Publishes Supplement and Protocol for Transition From IBOR to Alternative Benchmark Rates

On October 23, 2020, the International Swaps and Derivatives Association (ISDA) published its long-awaited IBOR Fallbacks Supplement (Supplement) and IBOR Fallbacks Protocol (Protocol), marking a major milestone in the effort to transition derivatives markets from reliance on interbank offered rates (IBOR) such as the London Interbank Offered Rate (LIBOR) to alternative benchmark rates.[1]

Fallback rates apply to derivatives and other contracts in the event that the benchmark rate that a contract otherwise uses becomes unavailable or is no longer representative of the underlying market and economic reality that the rate is intended to measure.[2] Robust fallback language is critical to mitigating financial and litigation risk, particularly where a contract references a benchmark rate that may become permanently unavailable, as may be the case with LIBOR after 2021. By publishing the Supplement and Protocol, ISDA aims to offer improved fallbacks for new derivatives transactions that reference IBORs and are documented under standard form ISDA agreements, and a mechanism to include those fallbacks in existing (*i.e.*, "legacy") transactions.

2006 ISDA Definitions

ISDA's 2006 Definitions provide a standardized framework for the interpretation of derivatives transactions that are documented under ISDA Master Agreements.[3] Prior to the Supplement, the 2006 ISDA Definitions called for the counterparty acting as the calculation agent for a transaction to calculate a fallback rate based on quotations obtained by polling banks.[4] This was viewed by many as inadequate to address a situation in which a particular IBOR becomes permanently unavailable. Banks have become less willing

[1] Press Release, "ISDA Launches IBOR Fallbacks Supplement and Protocol," ISDA (Oct. 23, 2020). For more on the transition from IBORs to alternative benchmark rates, see Skadden's August 15, 2017, March 28, 2018, and September 2, 2020, client alerts.

[2] *See* ISDA, "Understanding IBOR Benchmark Fallbacks" at 1 (2020) [hereinafter "Understanding IBOR Benchmark Fallbacks"].

[3] *See* ISDA, "2006 ISDA Definitions" (last visited Oct. 23, 2020).

[4] *See* ISDA, *et al.*, "IBOR Global Benchmark Transition Report" at 15 (June 2018) [hereinafter "IBOR Global Benchmark Transition Report"]. The 2006 ISDA Definitions provide that if the relevant rate does not appear on the specified screen at the designated time, the calculation agent will conduct a poll of leading dealers in the London eurozone or the Tokyo interbank market (depending on the rate). If fewer than two quotations are provided, the calculation agent is required to poll major banks in New York, the eurozone, London, Zurich or Tokyo (again, depending on the rate). *Id.*

to submit to IBORs in light of potential liabilities arising from making judgment-based submissions, and may refuse to submit quotations to calculation agents for the same reason.[5] The 2006 ISDA Definitions did not address what counterparties should do if no reference banks provided quotations. Moreover, even if banks provide quotations, polls may still be impractical in the event that an IBOR is permanently unavailable, because the calculation agent would then have to carry out the poll for each calculation period for the remaining life of the transaction.[6]

IBOR Fallbacks Supplement and Protocol

The Supplement applies to new cleared and uncleared derivatives contracts that incorporate the 2006 ISDA Definitions and reference any of the IBORs that the Supplement covers, which include U.S. dollar, pound sterling, Swiss franc, Japanese yen and euro LIBOR. Under the Supplement, if an IBOR becomes unavailable based on specified events, or, in the case of LIBOR, the relevant regulatory supervisor declares the rate unrepresentative, contracts referencing that IBOR will fall back to adjusted versions of a risk-free rate identified for the relevant currency of that IBOR. For example, for a given tenor of U.S. dollar LIBOR, the fallback rate is the Secured Overnight Financing Rate (SOFR), compounded over the relevant tenor, plus a spread adjustment comprised of the median of the historical difference between U.S. dollar LIBOR for the relevant tenor and the compounded SOFR rate for the same tenor observed over a five-year lookback period.[7] There are three circumstances (called “Index Cessation Events”) that will trigger a fallback:

- A public statement or publication of information by or on behalf of an IBOR’s administrator announcing that it has ceased, or will cease, to provide the IBOR permanently or indefinitely, and at the time of the statement or publication, no successor administrator will continue to provide the IBOR.
- A public statement or publication of information by (a) the regulatory supervisor for an IBOR’s administrator, (b) the central bank for the currency of the IBOR, (c) a resolution authority with jurisdiction over the IBOR’s administrator, or (d) a court or entity with similar insolvency or resolution authority over the IBOR’s administrator, stating that the administrator has ceased, or will cease, to provide the IBOR permanently or indefinitely, and at the time of the statement or publication, no successor administrator will continue to provide the IBOR.
- In the case of U.S. dollar, pound sterling, Swiss franc, Japanese yen or euro LIBOR, a public statement or publication of information by the regulatory supervisor for the administrator of the rate announcing that (a) the regulatory supervisor has determined that the rate is no longer, or as of a specified date will no longer be, representative of the underlying market and economic reality that the rate is intended to measure, and that such representativeness will not be restored, and (b) the regulatory supervisor intends for the statement or publication to engage contractual fallback triggers.[8]

The Supplement provides that, upon the occurrence of an Index Cessation Event, fallbacks will be triggered on the first date on which the relevant IBOR is no longer provided or, with respect to a LIBOR rate, the first date on which the rate is nonrepresentative, even if it continues to be published (*i.e.*, the “Index Cessation Effective Date”).[9]

The Protocol allows counterparties to derivatives transactions to bilaterally amend their existing uncleared transactions to incorporate the fallbacks in the Supplement.[10] Counterparties can adhere to the terms of the Protocol online through ISDA’s website by executing and uploading a short-form letter of adherence.[11]

[5] *See* ISDA, *et al.*, “IBOR Global Benchmark Survey 2018 Transition Roadmap” at 3 (Feb. 2018).

[6] *See* IBOR Global Benchmark Transition Report at 15.

[7] *See, e.g.*, ISDA, “Amendments to the 2006 ISDA Definitions to Include New IBOR Fallbacks,” at 17-21 (Oct. 23, 2020) [hereinafter “Supplement”]; Understanding IBOR Benchmark Fallbacks at 1. SOFR is published and administered by the Federal Reserve Bank of New York (FRBNY), and ISDA has selected Bloomberg Index Services Limited to calculate and publish the adjusted SOFR fallback rate. *See* Federal Reserve Bank of New York, “Secured Overnight Financing Rate Data” (last visited Oct. 26, 2020); Press Release, “Bloomberg Selected as Fallback Adjustment Vendor,” ISDA (July 31, 2019). If the primary intended fallback rate itself becomes unavailable, the Supplement provides for additional fallbacks. For example, for U.S. dollar LIBOR, if SOFR is temporarily unavailable, the most recent SOFR rate is used. If, however, SOFR is permanently or indefinitely unavailable, the Supplement provides for a waterfall of additional replacement rates: first, a successor rate selected by the Federal Reserve Board (FRB), FRBNY or a committee designated by either the FRB or FRBNY; second, the Overnight Bank Funding Rate published by the FRBNY; and third, the short-term interest rate target set by the Federal Open Market Committee (FOMC) and published on the Federal Reserve’s website, or the midpoint of the short-term interest rate target range, if the FOMC does not target a single rate. *See* Supplement at 18-20.

[8] Currently, LIBOR is administered by ICE Benchmark Administration, which is regulated by the U.K. Financial Conduct Authority (FCA).

[9] *See* Supplement at 90-91. The FCA has urged market participants, in considering potential fallbacks, to account for the possibility that the FCA will use its supervisory power to declare LIBOR unrepresentative of its underlying market even if the rate is still available. FCA, “Speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, Delivered at the International Swaps and Derivatives Association (ISDA) Annual Legal Forum” (Jan. 28, 2019).

[10] *See* ISDA, “ISDA 2020 IBOR Fallbacks Protocol” (Oct. 23, 2020) [hereinafter “Protocol”]. According to ISDA, clearinghouses “have indicated they will use the powers in their rule books to implement the fallbacks in all of their legacy cleared derivatives transactions as of the effective date of the updates.” ISDA, “Understanding IBOR Benchmark Fallbacks” at 1 (2020).

[11] *See* Protocol at 1.

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Although there is currently no closing date for parties to adhere to the Protocol, ISDA has stated that it has discretion to impose such a closing date upon 30 days' public notice.[12] The Supplement, and any amendments made by the Protocol, will be effective on January 25, 2021.

Many transition challenges remain, notwithstanding ISDA's Supplement and Protocol. As just one example, fallback language in products that derivatives are used to hedge may vary, which could result in a potential mismatch in fallback rates between cash market products such as loans and related hedging transactions.[13] However, with respect to derivatives contracts, the Supplement and Protocol provide for many market participants a uniform approach to the implementation of enhanced fallbacks.

[12] *See id.* at 1 (stating that such notice will be provided on the "ISDA 2020 IBOR Fallbacks Protocol" section of ISDA's website or "by other suitable means").

[13] *See*, *e.g.*, ISDA, "Consultation on Pre-Cessation Issues for LIBOR and Certain Other Interbank Offered Rates (IBORs)" at 12 (May 16, 2019). While the Alternative Reference Rates Committee, a private-public working group convened by the FRBNY in 2014 to ensure markets can successfully transition from U.S. dollar LIBOR to SOFR, has issued its own recommended fallbacks for cash market products, there is currently no uniform solution to implement fallbacks for this diverse category of products. *See*, *e.g.*, ARRC, "Fallback Contract Language" (last visited Oct. 28, 2020) (providing recommended fallback language for various cash market products such as adjustable rate mortgages, bilateral business loans and floating rate notes).

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