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07 / 25 / 19

SEC Staff Encourages Proactive Approach to Libor Transition Issues

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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On July 12, 2019, the staff of the Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant (Staff) of the Securities and Exchange Commission (SEC) issued a public statement regarding the expected transition away from the London Interbank Offered Rate (Libor) as a benchmark rate. In particular, the Staff's statement encourages market participants, including public companies, investment advisers, investment companies and broker-dealers, to proactively assess material risks as they transition away from Libor.

Companies should consider the Staff's guidance and overarching theme of transparency on an ongoing basis as they prepare periodic reports. Below is a brief summary of the key takeaways from the Staff's statement.

Background

Libor is a floating-rate benchmark that has served as the primary reference rate for various commercial and financial contracts, including corporate and municipal bonds and loans, floating rate mortgages, asset-backed securities, consumer loans, and interest rate swaps and other derivatives, for decades. Libor's susceptibility to manipulation, as exposed by a number of scandals in 2012, along with changes in the very nature of the transactions underlying it, has led to concerns that Libor is an increasingly unreliable benchmark. As a result, a global effort is underway to discontinue the use of Libor by the end of 2021. A number of banks are expected to stop reporting information used to set Libor after 2021. As regulators and market participants seek to avoid business and market disruptions resulting from the discontinuation of Libor, implementing alternative reference rates in advance of the discontinuation has become vital.[1]

The SEC has expressed urgency regarding preparation for the transition. In a press release announcing the Staff's statement, SEC Chairman Jay Clayton observed that "the transition away from LIBOR is gaining some much needed traction, but, as the [S]taff's statement makes clear, significant work remains." Clayton drew particular attention to the Staff's observation that "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."

[1] In the United States, a group 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 alternative rate for US dollar 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, representing a liquid market with daily volumes regularly in excess of $800 billion. Some market participants are also considering other US dollar reference rates for certain instruments.

Key Takeaways

The Staff's statement notes that the Staff is actively monitoring the extent to which market participants are identifying and addressing risks related to the transition from Libor. The Staff highlighted a number of specific considerations.

Existing Contracts

With respect to companies' existing contracts, the Staff advised companies to identify those that extend past 2021 to determine if there are any interest rate provisions that reference Libor and to consider potential uncertainty in the interpretation of these contracts. In particular, the Staff advised that companies consider the following questions as they seek to understand and mitigate any 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, should actions be taken 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?
- 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 effectiveness of the company's applicable hedging strategy?
- Does use of an alternative reference rate introduce new risks that need to be addressed? For example, for companies that have relied on Libor in pricing assets as a natural hedge against increases in costs of capital or funding, will the new reference rate behave similarly? If not, what actions should be taken to mitigate this new risk?

New Contracts

With respect to new contracts, the Staff suggested referencing an alternative rate (such as SOFR) or, where new contracts reference Libor, to include fallback language. The Staff's statement notes that the Alternative Reference Rates Committee has published recommended fallback language for specific contexts and that other industry groups are developing fallback language as well.

Other Business Risks

The Staff also advised that companies should identify, evaluate and mitigate other consequences of the discontinuation of Libor on their business, such as on strategy, products, processes and information systems.

Market participants facing a significant impact may want to establish a task force to assess the impact of financial, operational, legal, regulatory, technology and other risks.

Division of Corporation Finance

In the Staff's statement, the Division of Corporation Finance highlighted specific disclosure considerations for market participants. In particular, it noted that Libor transition might require disclosure in companies' risk factors, management's discussion and analysis, board risk oversight, and financial statements.

In accordance with the overarching theme of a proactive approach to Libor transition risks, the Division of Corporation Finance also noted that companies should keep investors informed about their progress toward risk identification and mitigation and the anticipated impact on the company, if material. In doing so, the Division of Corporation Finance encouraged all 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.

Office of the Chief Accountant

The Office of the Chief Accountant noted that it is actively monitoring the activities of financial statement preparers and auditors, standard setters such as the Financial Accounting Standards Board and other regulators to address financial reporting issues that might arise relating to the transition from Libor to an alternative benchmark rate. Specifically, the Office of the Chief Accountant noted that these issues could span a number of areas, including:

- modifications of terms within debt instruments;
- hedging activities;
- inputs used in valuation models; and
- potential income tax consequences.

Division of Investment Management

The Division of Investment Management noted that it also is actively monitoring the impact of the expected discontinuation of Libor on investment companies and advisers. Investment companies and advisers should consider whether any of the effects of the discontinuation of Libor constitute risks that should be disclosed to investors, even for funds that do not hold investments linked to Libor.

The Division of Investment Management also encouraged affected funds to provide investors with tailored risk disclosure that specifically describes the impact of the transition on their holdings. For instruments extending past 2021 that reference Libor, advisers should consider the effect of the discontinuation of Libor when recommending those instruments to clients or monitoring them for clients.

Division of Trading and Markets

The Division of Trading and Markets stated that it is monitoring the impact of the discontinuation of Libor on broker-dealers, central counterparties and exchanges. These entities are encouraged to analyze how the discontinuation of Libor will affect them and whether their clients and markets should be informed of related risks.

Capital Markets Alert
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