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SEC Staff Provides Guidance on LIBOR Transition Risks

WRITTEN BY

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On July 12, 2019, the Securities and Exchange Commission ("SEC") published a staff statement[1] encouraging issuers and other market participants to actively manage their transition away from LIBOR[2] and fully disclose the risks they face from the change. Currently, private-sector banks report the information used in the formulation of LIBOR, but those banks are expected to cease reporting when their current reporting commitment ends in 2021. As a result, LIBOR may cease to be a useful quality for reference or cease being published entirely. The guidance provided in the SEC's staff statement addresses some of the challenges presented by the transition away from LIBOR.

The SEC staff emphasizes the need for market participants to identify existing contracts using LIBOR that extend beyond 2021 to determine the effect of discontinuance of LIBOR on those agreements. With respect to the affected contracts, the SEC directs parties to consider:

- if the agreements are individually or in the aggregate, material, what potential impact could the transition have on disclosure obligations and risk management policies;
- if no fallback language is provided, do parties need to be proactive and renegotiate with counterparties to address uncertainties;
- what alternative reference rate may be used as a replacement in the identified contracts, and does the alternative rate impact profitability, need adjustment, or have other fundamental differences requiring attention; and
- in regards to derivative contracts used to hedge floating-rate investments, what effect will the discontinuation have on the hedging strategy.

LIBOR appears in agreements in a multitude of ways and takes various forms, not just floating-rate obligations and derivatives, often as a trigger or back-up feature. Finding and understanding the function of those provisions that refer to LIBOR is a specialized skill requiring the guidance of a cautious reviewer.

The SEC staff also advises market participants to consider the effects in future contracts to determine if an alternative rate should be used or if the fallback language in the agreement is sufficient. Fortunately, the LIBOR transition has been in the works for quite some time and, as a result, most new credit agreements address the transition through robust LIBOR replacement provisions. However, issues can still arise, such as whether corresponding changes in hedges work the same way, leaving uncertain whether companies can continue their use of hedge accounting.

In addition to the general guidance provided above, division specific guidance was also included in the staff statement regarding the challenges presented by transitioning from LIBOR.

Division of Corporation Finance

The Division of Corporation Finance notes that a number of existing rules or regulations may require disclosure related to the expected discontinuation, including rules and regulations related to disclosure of risk factors, management's discussion and analysis, board risk oversight, and financial statements. The Division of Corporation Finance encourages companies to consider the following:

- the evaluation and mitigation of risks related to the discontinuation of LIBOR may span several reporting periods. This may require the need to consider disclosing the status of company efforts to date and the significant matters yet to be addressed;
- if a material exposure to LIBOR is identified but the impact is not yet quantifiable, consider disclosing that fact; and
- consider 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 be qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts impacted by LIBOR.

Division of Investment Management

The Division of Investment Management's specific guidance is targeted at investment companies and advisers, especially those who invest in LIBOR-referencing instruments, such as floating-rate debt, bank loans, LIBOR-linked derivatives, and certain asset-backed securities. The discontinuation of LIBOR may impact the functioning, liquidity, and value of these investments or require renegotiation of the investments. The Division of Investment Management recommends affected funds provide investors with tailored risk disclosures specifically describing the impact of their holdings, and additionally advisers should consider the effect of discontinuation on these instruments when recommending or monitoring them for clients.

Division of Trading and Markets

For broker-dealers, central counterparties and exchanges, the Division of Trading and Markets recommends that market participants analyze how the change will impact them – their business, systems, models, processes, risk management frameworks, and clients – and to respond accordingly. Special consideration should be given to whether the clients and markets should be informed of risks related to shifting away from LIBOR.

Office of the Chief Accountant

The Office of the Chief Accountant urges parties to be aware of the potential pervasive impact on a company's financial reporting from the transition from LIBOR, and the office warns that the impact from moving from LIBOR to another benchmark rate can have a significant impact on an entities' accounting. Both the Financial Accounting Standards Board and the International Accounting Standards Boards are working to address the problems created by the move from LIBOR, and the Chief Accountant's Office encourages constituent participation in the standard setting process.

Key Takeaways

The SEC staff statement is an important reminder that it is never too soon for potentially effected companies to deal with the transition from LIBOR and related disclosure requirements. The use of an alternative rate has the capability to cause value shifting issues that may lead to burdensome litigation, so experienced counsel should be sought to navigate concerns that arise.

We are continuing to monitor developments and will provide updates as necessary.

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[1] The statement can be viewed in its entirety at: https://www.sec.gov/news/public-statement/libor-transition#_ftn2 .

[2] LIBOR is an indicative measure of the average interest rate at which major global banks could borrow from one another. LIBOR is used extensively in the United States and globally as a benchmark or reference rate for various commercial and financial contracts.

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