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The SEC Weighs In on LIBOR Transition

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On July 12, 2019, the SEC published a Staff Statement on LIBOR Transition (Staff Statement), which contains useful indications of the regulator's thinking about the London Interbank Offered Rate (LIBOR) transition and also suggests concrete steps that market participants – including hedge funds – should take to address it. This article discusses the key takeaways of the Staff Statement for private fund managers.

For more by the author on the LIBOR transition, see "How Hedge Fund Managers Can Prepare for the Anticipated 'End' of LIBOR" (Aug. 24, 2017). For coverage of other U.K.-related issues, see "Brexit Remains an Immediate FCA Concern for 2019/2020, With Regulatory Evolution a Longer-Term Area of Interest" (Jul. 18, 2019).

The Anticipated End of LIBOR in 2021

The U.K. Financial Conduct Authority (FCA), which regulates LIBOR, has announced that, as of the end of 2021, it will no longer compel the panel of banks that contribute the submissions from which LIBOR is determined to make those submissions. At that time, while LIBOR will not necessarily cease publication, at least some of the panel banks are expected to stop making submissions, and the already fragile benchmark will further degrade such that it will eventually no longer be usable.

As a result, global efforts are underway to transition away from LIBOR as a benchmark. In the U.S., the Alternative Reference Rates Committee (ARRC) of the Federal Reserve Bank (Fed) of New York has designated a newly created benchmark called the Secured Overnight Financing Rate (SOFR) as the preferred successor to USD LIBOR.[1] Other successor rates have been recommended for other currencies and jurisdictions. The SEC noted that the transition away from LIBOR potentially affects $35 trillion in notional transactions that extend past 2021.

The SEC's Prior Comments on LIBOR Transition

The Staff Statement is not the SEC's first public comment on LIBOR transition. In November 2018, *The Wall Street Journal* reported that Kyle Moffatt, Chief Accountant at the SEC's Corporation Finance Division, stated, "To the extent that the phaseout of Libor is material to a company, . . . we would definitely expect a company to disclose that fact and describe the implications of the phaseout, including any associated risks, to investors." Moffatt also noted that those disclosures will be expected to change over time, adding, "With respect to both Libor and Brexit, the other thing to keep in mind is your disclosures need to evolve. Every quarterly period or annual period you need to make sure that you reassess your disclosure and add any updates."

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In December 2018, SEC Chair Jay Clayton gave a speech in New York and also testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs, in both cases highlighting LIBOR transition as a key risk that the SEC is monitoring. At the April 15, 2019, meeting of the SEC's Fixed Income Market Structure Advisory Committee, a panel of market participants discussed the implications of the transition from LIBOR for the corporate bond and municipal securities markets.

For additional commentary from Clayton, see "SEC Chair Clayton Details Eight Guiding Principles for Enforcement and Agency Strategies for Their Implementation" (Aug. 10, 2017).

These and other SEC statements to date have been high-level pronouncements identifying LIBOR transition as a risk and urging market participants to focus on it. The Staff Statement, however, contains the SEC's first detailed guidance on the subject. Now, the SEC has identified three key areas of focus – existing or "legacy" contracts; new contracts; and other business risks – and provided official staff guidance from four SEC divisions – Corporation Finance; Investment Management; Trading and Markets; and the Office of the Chief Accountant.

What the Staff Statement Means for Market Participants Generally

The headline message of the Staff Statement is that the SEC is paying close attention to LIBOR transition. Thus, market participants must take concrete steps to address it and be able to explain to the SEC (and others) what they are planning to do about it, as well as what they have done.

The Staff Statement notably does not include guidance from the Office of Compliance Inspections and Examinations or the Division of Enforcement. Nonetheless, the SEC can be expected to treat LIBOR like other "key risks" it has identified, such as cybersecurity and Brexit. With respect to cybersecurity, the SEC has conducted sweep examinations, included it as a prominent topic in routine examinations and brought enforcement proceedings. Similar examination and enforcement activity related to LIBOR transition thus seems likely.

See "How Fund Managers Can Prepare for the Latest SEC Cyber Sweeps" (Jul. 11, 2019). See also "How Hard Is Brexit Expected to Impact Alternative Fund Managers?" (Dec. 13, 2018); and "FCA Executive Director Outlines Regulator's Brexit Preparations and Expectations for Fund Managers" (Aug. 2, 2018).

The urgent tone of the document is consistent with that of other recent official-sector messaging about LIBOR transition in both the U.S. and abroad. For example, at the beginning of June 2019, Fed Vice Chair for Supervision Randal K. Quarles gave a speech in New York noting that LIBOR transition is already a part of the Fed's supervisory work with banks. In the speech, Quarles also admonished market participants to cease using LIBOR, noting that "after LIBOR stops, it may be fairly difficult to explain to those who may ask exactly why it made sense to continue using a rate that you had been clearly informed had such significant risks attached to it."

Some U.K. regulators have taken an even more insistent tone. For example, the FCA has stated that it may use its Senior Managers Regime

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to hold banks accountable for ensuring that contracts are switched from LIBOR to the Bank of England's preferred sterling overnight rate, SONIA, with possible penalties for foot-dragging, including fines or the loss of banking licenses.

See our two-part series on the U.K. Senior Managers Regime: "Responsibilities of Senior Managers" (Apr. 25, 2019); and "Certification Regime and Conduct Rules" (May 9, 2019).

The SEC nevertheless did not go as far as to require specific actions. For example, while noting the ARRC's endorsement of SOFR as a replacement rate, the Staff Statement says, "The Commission does not endorse the use of any particular reference rate," although it also says that, "The Commission staff is monitoring whether the adoption of a variety of replacement rates for USD LIBOR instead of the emergence of a dominant successor could limit the effectiveness of all replacement benchmarks."

What the Staff Statement Means for Hedge Funds

The Staff Statement contains numerous recommendations and questions, which hedge fund managers should review and consider carefully and which illustrate how LIBOR transition implicates every aspect of a hedge fund's business – legal, compliance, governance, investor relations, investment strategy, trading, technology and operations. Indeed, the SEC noted that "prudent risk management may necessitate the establishment of a task force to assess the impact of financial, operational, legal, regulatory, technology, and other risks."

See our two-part series "RCA Symposium Explores Common Examination Risk Areas": Part One (Feb. 28, 2019); and Part Two (Mar. 7, 2019).

Some of the SEC's recommendations and questions are expressly directed at investment advisers, while others are of more general application and some may have little or no relevance to the hedge fund industry. The information that is most relevant to hedge fund managers falls into three categories:

1. inventory, planning and strategy;
2. portfolio impacts; and
3. disclosures and financial reporting.

Inventory, Planning and Strategy

Much of the SEC's guidance focuses on the need for market participants to assess LIBOR exposures and develop plans and strategies to address the risks they pose.

The Staff Statement starts with "legacy" contracts, which constitute perhaps the greatest challenge and are the most likely source of disputes. Those contracts may have no or inadequate provisions to address a permanent end to LIBOR and, the SEC noted, "In certain cases, for example, a floating rate obligation may become a fixed rate obligation."

The SEC recommended that market participants identify and analyze existing contracts extending beyond 2021 to find and evaluate their fallback provisions and develop a strategy to address those provisions, as well as other risks they pose. For some managers, an inventory of legacy contracts may require reviewing only a few documents, while others may have dozens, hundreds or even thousands of potentially relevant documents, including

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multiple documents for a single trade in some cases, such as swaps. The SEC also noted that USD LIBOR is not the only benchmark undergoing transition, and "[a]lthough [the Staff Statement] focuses on LIBOR, market participants should also consider examining their exposures to other reference rates undergoing transitions."

An inventory is just the beginning; firms must also develop plans to address LIBOR-transition risks from legacy contracts. This may involve a variety of activities, including negotiations with counterparties to amend agreements; modification of IT systems; changes to hedging strategies; liquidation of positions; and changes to policies and procedures. As the SEC correctly observed, "There are rarely quick fixes to these types of issues and the Commission staff encourages market participants to focus on them now to avoid business and market disruptions after 2021."

New LIBOR-linked contracts and instruments present another, separate challenge. The Staff Statement discusses the fallback language for new issuances of floating-rate notes, syndicated loans, bilateral business loans and securitizations that has been developed by the ARRC, as well as the forthcoming fallback language for swaps that the International Swaps and Derivatives Association is developing. Unlike many regulators both in the U.S. and elsewhere, however, the SEC did not admonish market participants to stop using LIBOR or investing in LIBOR-linked instruments altogether. Although one obvious way to avoid some of the work that LIBOR transition requires for both legacy and new transactions would be to reduce LIBOR exposures and avoid new LIBOR-linked investments, the Staff Statement makes clear that the SEC is not going to recommend or direct specific investment decisions.

In addition to recommending inventory and planning for both existing and new transactions, the SEC urged that "Market participants should stay informed regarding the progress of the various ARRC working groups," which are expected to continue to develop new fallback language and other resources.

Portfolio Impacts

The Staff Statement correctly observes that LIBOR-linked investments and positions not only present an operational challenge but will increasingly affect funds' portfolios more directly, with potential impacts on pricing, trading, risk management and valuation. For example, the SEC noted that "investments without fallback language, or with fallback language that does not contemplate the discontinuation of LIBOR, could become less liquid and/or change in value as the date approaches when LIBOR will no longer be updated." Therefore, it is important for managers to understand what is in the documents underlying their portfolio positions. What once were thought of as "standard" or "boilerplate" terms may now have material effects on how positions will perform; be traded; be priced; or be hedged and otherwise risk-managed, and how they will be valued.

Importantly, LIBOR-transition risks are relevant to managers in virtually all investment strategies. While these risks are most concentrated in funds that invest in instruments that directly reference LIBOR, managers of equity-focused funds and others that do not invest extensively in LIBOR-linked instruments are not immune. As the

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SEC noted, "closed end funds and business development companies that engage in direct lending may need to renegotiate the terms of contracts extending past 2021 that do not address the discontinuation of LIBOR," and "funds that have received exemptive orders that reference LIBOR (such as certain interfund lending orders) should consider evaluating possible implications for terms and conditions of their relief." Equity-focused investors should take particular note of the guidance in the Staff Statement from the Division of Corporation Finance, which tells issuers "it is important to keep investors informed about the progress toward risk identification and mitigation, and the anticipated impact [of LIBOR transition] on the company, if material."

Disclosures and Financial Reporting

LIBOR transition will also have a variety of impacts on hedge funds' disclosures to investors and others, as well as their financial reporting.

The Division of Investment Management "encourages affected funds to provide investors with tailored risk disclosure that specifically describes the impact of the transition on their holdings," rather than "more generic disclosure that division staff believes is generally less helpful to investors." Managers should therefore consider adding disclosures about their LIBOR-related risks and LIBOR transition activities to private placement memoranda, due diligence questionnaire responses and other disclosures to existing and potential investors. Moreover, just as the SEC can be expected to inquire of managers about these topics, investors, allocators and due diligence firms can be expected to start asking questions as well.

For SEC scrutiny of inadequate disclosures, see "SEC Settles With 79 Investment Advisers Under Its Share Class Selection Disclosure Initiative" (Apr. 4, 2019); "Transamerica Entities Fined $97.6 Million for Use of Faulty Quantitative Investment Models and Misleading Disclosures Regarding Quant Mutual Funds" (Oct. 4, 2018); and "$97-Million SEC Settlement Highlights Perils of Inaccurate Disclosures and the Agency's Continued Focus on Conflicts of Interest and Client Overcharges" (May 25, 2017).

In a similar vein, the Staff Statement suggests managers should be attentive to the impact of LIBOR transition on valuation and financial reporting. The Office of the Chief Accountant observed that "[a]n interest rate benchmark can have a pervasive impact on a company's financial reporting," and "[t]ransitioning from one benchmark rate to another benchmark rate can also have a significant impact on a company's accounting." The SEC identified a number of examples of areas in which LIBOR transition may affect financial reporting and accounting, including modification of terms of debt instruments, hedging activities, inputs used in valuation models and income tax consequences. The SEC specifically "encourage[s] constituent participation in the standard-setting process as both the [Financial Accounting Standards Board] and the [International Accounting Standards Board] will benefit from the active engagement and involvement of the various parties involved in the financial reporting ecosystem."

In addition to that external participation, managers should revisit their internal policies and procedures. In particular, managers should consider whether valuation policies and procedures need to be updated to ensure valuations for net asset value and other purposes continue to be accurate throughout

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the transition. Managers should also engage with their auditors to understand and proactively address implications for hedge accounting and tax consequences.

See "Is the Use of an Independent Valuation Firm Superior to a Manager's Internal Valuation Process?" (Apr. 23, 2015). See also "Will Inadequate Policies and Procedures Be the Next Major Focus for SEC Enforcement Actions?" (Nov. 30, 2017).

Conclusion

Now that the SEC has spoken in detail about the issue of LIBOR transition, hedge fund managers should ensure they complete their evaluations of their funds' LIBOR-transition-related risks promptly and be in position to articulate to the SEC and others plans for remediating and mitigating those risks that are tailored to their particular businesses.

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[1] LIBOR is an unsecured term rate that includes bank credit risk, while SOFR is a secured overnight "risk-free" rate. While the official sector backs SOFR, there is disagreement among market participants about its appropriateness in specific applications.

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