

July 9, 2020

## EXAMINATIONS

# How Advisers Can Prepare for OCIE Exams on the Transition From LIBOR

By [Anne E. Beaumont](#), [Friedman Kaplan Seiler & Adelman LLP](#)

---

In July 2017, the head of the U.K. Financial Conduct Authority (FCA) – which regulates the London Interbank Offered Rate (LIBOR) – 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. Although LIBOR will not necessarily cease publication at that time, at least some of the panel banks are expected to stop making submissions, and the already fragile benchmark will further degrade until it is no longer usable. There is also a possibility that even before the end of 2021, LIBOR could be deemed “non-representative,” such that it would cease to be usable by many market participants. The transition away from LIBOR potentially affects hundreds of trillions of dollars in notional transactions that extend past the end of 2021.

In its [2020 Examination Priorities](#) published in January, the SEC’s Office of Compliance Inspections and Examinations (OCIE) stated that it will “closely track and evaluate the impact of several major risk themes affecting its registrant population, including . . . the industry’s transition away from LIBOR.” On June 18, 2020, OCIE published a [risk alert](#) (Risk Alert) announcing that “OCIE intends to engage with registrants through examinations to assess their preparations for the expected

discontinuation of LIBOR and the transition to an alternative reference rate.” This article explores the significance of this Risk Alert for investment managers that expect or are preparing for SEC examinations in the months to come.

For more by Beaumont on the LIBOR transition, see [“The SEC Weighs In on LIBOR Transition”](#) (Aug. 8, 2019); and [“How Hedge Fund Managers Can Prepare for the Anticipated ‘End’ of LIBOR”](#) (Aug. 24, 2017).

## The Anticipated End of LIBOR in 2021

Since the FCA announcement, global efforts have been underway to transition away from LIBOR as a benchmark. In the U.S., those efforts are led by the Alternative Reference Rates Committee (ARRC) of the Federal Reserve Bank of New York, which has designated a newly created benchmark called the Secured Overnight Funding Rate (SOFR) as the preferred successor to LIBOR. In addition, the ARRC and others, including the International Swaps and Derivatives Association (ISDA), are developing resources to assist market participants with the transition, including model contractual provisions, best practices and transition checklists.

## The SEC's Prior Comments on LIBOR Transition

The Risk Alert is only the latest in a series of increasingly specific and detailed messages from the SEC urging registrants to prioritize and accelerate work toward the LIBOR transition. The Risk Alert follows the SEC's July 2019 [staff statement](#) (Staff Statement), which was its first detailed guidance on the topic. The Staff Statement highlighted risks – including certain risks specific to investment managers – for market participants to consider as they transition away from LIBOR.

In addition, both before and since the Staff Statement, SEC leadership, including Chair Jay Clayton, have given numerous public speeches in which they have highlighted the LIBOR transition as a key risk the SEC is monitoring. The LIBOR transition also is a focus of the SEC's Fixed Income Market Structure Advisory Committee and its Investor Advisory Committee.

The Risk Alert is noteworthy for both its content and its timing. It echoes messaging from other “official sector” organizations, such as the FCA, indicating directly and indirectly that the end-2021 date for the transition away from LIBOR will not be extended due to the coronavirus pandemic. In addition, the week after OCIE's publication of the Risk Alert, the FCA and the U.K. government [announced](#) significant new measures to further the LIBOR transition.

## The Sample Information Request List

The Risk Alert itself is brief and relatively conclusory. OCIE, however, has taken the highly unusual step of including a sample list of the types of information and documentation it may ask for regarding LIBOR discontinuation preparations, which gives registrants insight into the aspects of the LIBOR transition that are likely to be the focus of future exams.

The scope of the sample list is extremely broad and potentially touches virtually every aspect of an investment manager's business. Registrants may be asked about numerous aspects of the substance of their LIBOR transition plans, as well as the development of those plans, including:

- the personnel and functions involved;
- their meetings and communications; and
- the use of third parties.

Those topics echo and expand on issues discussed in the Staff Statement, particularly the Division Specific Guidance from the SEC Division of Investment Management.

Perhaps most interesting – and potentially challenging for some managers – are references to various types of “documentation.” For example, the sample list includes documentation of:

- “any analysis performed to identify contracts or obligations held and/or issued by registrant or its investors that may be affected by the LIBOR Transition and any remediation plans thereof”;

- “[a]ny written assessments, strategic plans (including remediation plans, as applicable), roadmaps, or timelines prepared by or for registrant regarding preparation for the LIBOR Transition”; and
- “[m]aterials referencing the LIBOR Transition provided to registrant’s board of directors.”

These items indicate OCIE expects at least some registrants to have already started work and made significant progress on the work necessary to produce that documentation. This would be consistent with the Staff Statement, which notes that “the Commission staff encourages market participants who have not already done so to begin the process of identifying existing contracts that extend past 2021 to determine their exposure to LIBOR.” It also noted that the risk to market participants from the expected discontinuation of LIBOR “will be exacerbated if the work necessary to effect an orderly transition . . . is not completed in a timely manner.” Investment managers that did not take those directives to heart when the Staff Statement was published a year ago may struggle to produce documentation that will satisfy OCIE examiners.

As with the Staff Statement, the Risk Alert is directed to all types of registrants potentially subject to OCIE exams, including not only investment managers, but also public companies, broker-dealers and investment companies. Although, as noted above, the Staff Statement included Division Specific Guidance applicable to investment managers from the SEC Division of Investment Management, the Risk Alert and its sample list do not have separate lists for different types of registrants.

Nonetheless, the approach used in the Staff Statement indicates that the SEC recognizes there is not a one-size-fits-all approach to LIBOR transition. Therefore, it seems unlikely that OCIE will expect every registrant, or even every type of registrant, to have done the same things, made the same progress and have the same documentation. Moreover, a number of the items on the sample list – such as those that refer to “the provision of advice to clients regarding the replacement of LIBOR” and “LIBOR-linked instruments or contracts recommended or sold to clients” – clearly would not apply to investment managers.

See [“How CCOs Can Use a Sample OCIE Information Request Letter to Improve Their Compliance Programs”](#) (Jul. 25, 2019).

## Resources for OCIE Exams That Include the LIBOR Transition

The publication of the Risk Alert confirms that the LIBOR transition now must be part of every investment manager’s preparation for an SEC exam.

### SEC Resources

At a minimum, investment managers should take advantage of the information the SEC has already published about what it is looking for in registrants’ LIBOR transition preparations. (The SEC has done far more than any other U.S. regulator in that regard.) Thus, investment managers should carefully review the Staff Statement as well as the sample information list that is part of the Risk Alert.

## ARRC Resources

In addition, the ARRC – of which the SEC is a member – has published several resources that may be useful to investment managers when preparing for the LIBOR transition, including:

- [Recommended Best Practices for Completing the Transition from LIBOR;](#)
- [Recommended Best Practices for Vendors on Completing the Transition from LIBOR; and](#)
- [Buy-Side/Asset Owner Checklist](#) for the adoption of SOFR.

Given the SEC’s participation in the development and approval of the Best Practices and the Buy-Side Checklist, those documents can be expected to inform OCIE’s examination work.

The ARRC’s two Best Practices, both of which were published in May 2020, are designed to assist a wide variety of market participants and their third-party vendors with preparing for LIBOR cessation. They set forth recommended timelines and intermediate steps market participants can take to achieve successful transitions. Importantly, the ARRC recommended a number of intermediate steps that should have been completed already, with additional deadlines and timeframes arising in rapid succession in the year ahead. Also, the best practices document for vendors highlights that investment managers must also be aware of their service providers’ LIBOR transition efforts.

## Other Resources

In addition to the ARRC’s resources, industry- and asset class-specific resources may be

helpful to investment managers and other buy-side market participants for navigating OCIE exams that touch on LIBOR transition. For example, the Alternative Investment Management Association (AIMA) has published several articles focused on the specific implications of LIBOR transition for investment managers, including a recent “how-to” [article](#) with a list of key questions to consider.

For more from AIMA, see “[AIMA Report Outlines Adoption, Challenges and Prospects for Use of Alternative Data by Hedge Fund Managers](#)” (Jun. 4, 2020); “[AIMA Survey Examines Evolution in the Ways That Managers Align With Investors](#)” (Nov. 7, 2019); and “[A Recap of AIMA’s 2019 Global Policy & Regulatory Forum](#)” (May 23, 2019).

Investment managers that use derivatives should acquaint themselves with ISDA’s substantial work toward LIBOR transition and consult the organization’s recently launched [resource page](#) on the topic. With respect to derivatives in particular, OCIE examiners should be expected to ask whether an investment manager has decided to adhere to the anticipated ISDA protocol that will amend documentation for cleared derivatives transactions, as well as how that decision was or will be arrived at and communicated to relevant constituencies, such as fund directors, investors and others. In addition, investment managers should have answers to OCIE examiners’ inquiries about how they plan to deal with uncleared derivatives transactions that reference LIBOR, which will not fall within the expected ISDA protocol.

See “[ISDA 2018 U.S. Resolution Stay Protocol: Should Fund Managers Adhere or Not?](#)” (Nov. 8, 2018).

## Likely Areas of Focus

One LIBOR transition issue that is likely to be of major concern for OCIE examiners is the so-called “tough legacy” problem. That refers to the situation where an existing LIBOR-linked contract that extends beyond the end of 2021 lacks a robust (or any) LIBOR fallback provision and cannot be amended. Those contracts are the most significant source of potential disputes when LIBOR ceases to be available. For that reason, OCIE examiners are likely to inquire about the extent of investment managers’ tough legacy holdings and their plans for dealing with them – including trading out of or selling them and valuing them as the end of 2021 approaches – and for avoiding exacerbating them.

In addition to tough legacy issues, OCIE exams of investment managers also can be expected to target LIBOR transition issues by way of many of the same topics that have been subjects of exams in recent years, such as investor disclosures and reporting; valuation; governance; and conflicts of interest. Indeed, only days after publication of the Risk Alert, OCIE published another [risk alert](#) regarding common deficiencies and compliance issues from recent private fund exams, which, together with the [2020 Examination Priorities](#), should be required reading for any investment manager facing an OCIE exam and should be considered with the LIBOR transition in mind.

For more on other recent targets of OCIE, see [“OCIE’s Targeting of ESG Investing Practices in Recent Examinations and What It Means for Hedge Fund Managers”](#) (Jun. 11, 2020); and [“OCIE Risk Alerts on Reg BI and Form CRS: What to Expect in Future Exams \(Part One of Two\)”](#) (May. 28, 2020).

*Anne E. Beaumont is a litigation partner in the New York office of Friedman Kaplan Seiler & Adelman LLP and heads the firm’s LIBOR transition task force. Her practice focuses on representation of investment and asset management firms and their managers and investors, as well as financial services firms in litigation matters and disputes involving complex financial products and transactions. Beaumont also counsels and trains financial services industry clients, investment managers and asset management firms on legal compliance, due diligence and other issues, and she advises investment and asset management firms and their professionals on employment and separation issues and disputes.*