Securities Regulation Daily Wrap Up, TOP STORY—SEC warns market participants to prepare for the end of LIBOR now, (Jul. 15, 2019)

Securities Regulation Daily Wrap Up

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With LIBOR expected to be discontinued after 2021, the Commission urged market participants to take action now to identify the risks associated with the transition away from the benchmark rate.

In a staff statement, the SEC has cautioned that market participants such as public companies, investment advisers, investment companies, and broker-dealers should proactively manage the transition away from LIBOR due to the impact on financial markets upon its demise and potential risks that may arise. Chairman Jay Clayton urged market participants to identify existing contracts that extend past 2021 to determine their exposure to LIBOR, stating, "waiting until all open questions have been answered … could likely prove to be too late to accomplish" the transition.

LIBOR. LIBOR, a reference rate measuring the average interest rate at which major global banks can borrow from another, is used extensively around the world for commercial and financial contracts. It is anticipated that institutions currently using reporting information used to set LIBOR will stop doing so after their current reporting commitments end after 2021. As its expiration date draws near, regulators in the U.S. are working to replace LIBOR with alternative reference rates.

In the U.S., the Alternative Reference Rates Committee (ARRC) has identified the Secure Overnight Financing Rate (SOFR) as the preferred alternative rate for USD LIBOR. The statement noted that the SEC does not endorse any particular reference rate, but that the staff is monitoring whether the adoption of a variety of replacement rates instead of a dominant successor could limit the effectiveness of the replacement benchmarks.

Transitioning from LIBOR. The statement outlines a number of issues that market participants should consider ahead of the transition, including how it will impact existing and new contracts, as well as other business risks that may arise. Market participants who have not yet begun the process of identifying existing contracts that extend past 2021 should do so now to determine their exposure to LIBOR, the SEC advised. By focusing on them now, market participants can help avoid business and market disruptions after 2021. The statement outlines several questions that should be considered, including how to mitigate risks for contracts without fallback language, what alternative rate might replace LIBOR in existing contracts, and the effect LIBOR's discontinuation might have on hedging strategy.

Regarding new contracts, the staff noted that the ARRC has published recommended fallback language that seeks to provide interest rate provisions that will function upon the discontinuation of LIBOR, including the definition of terms such as benchmark replacement and benchmark transition events. In addition, the International Swaps and Derivatives Association (ISDA) is developing fallback language with feedback from the industry.

Beyond contracts, the SEC is also encouraging market participants to consider other consequences of the discontinuation of LIBOR on businesses, such as strategy, products, processes, and information systems. The statement gives the example of ensuring that business IT systems are able to incorporate new instruments and rates with features that differ from LIBOR. Market participants may want to establish a task force on how to mitigate risks to the business, the Commission recommended.

SEC guidance. The statement also provided guidance specific to the SEC's Divisions of Corporation Finance, Investment Management, and Trading and Markets, as well as the Office of the Chief Accountant. From CorpFin, the staff points out that existing regulations may require disclosure relating to the discontinuation of LIBOR, such as risk factors, MD&A, board risk oversight, and financial statements. The statement identified the real estate, banking, and insurance industries as those most frequently providing LIBOR transition disclosure.

IM noted that the discontinuation may impact the functioning, liquidity, and value of investments in instruments that reference LIBOR, so it is monitoring the impact it will have on investment companies and advisers. Even funds that do not invest in LIBOR-linked instruments could be impacted, such as business development companies that engage in direct lending or funds that have received exemptive relief referencing LIBOR.

TM is monitoring how the discontinuation of LIBOR will affect broker-dealers, central counterparties, and exchanges. TM noted that affected entities may: issue instruments or be a party to transactions that reference LIBOR; own investments that reference LIBOR; have LIBOR-based hedges in place; and recommend securities that reference LIBOR.

According to OCA, transitioning from one benchmark rate to another can have a significant impact on a company's financial reporting. OCA noted in particular that issues may arise related to the accounting and financial reporting for modifications of terms within debt instruments; hedging activities; inputs used in valuation models; and consequences related to income taxes. OCA also noted that FASB has added a project to address accounting and reporting implications of the discontinuation of LIBOR and that the International Accounting Standards Board has recently published an exposure draft addressing hedge accounting issues related to replacing an existing interest rate benchmark.

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