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SEC Staff Issues Key Considerations on LIBOR Transition: Latham & Watkins

As a major LIBOR transition milestone approaches, a Staff Statement provides key considerations for market participants regarding their obligations.

On December 7, 2021, the Staff of the Securities and Exchange Commission (SEC) issued a [statement](#) (the Statement) on the transition away from the London Interbank Offered Rate (LIBOR). The transition away from LIBOR is reaching an inflection point as the publication of the USD LIBOR benchmark for the 1-week and 2-month USD LIBOR maturities and many non-USD LIBOR maturities cease immediately after December 31, 2021.[1] The SEC, like other regulators around the world, continues to emphasize its expectation that market participants understand the risks associated with LIBOR transition and take appropriate action to move to alternative rates in a manner that protects customers, counterparties, the firm itself, and the capital markets more broadly.

The Statement provides guidance for broker-dealers and registered investment advisers as they approach the imminent transition away from LIBOR, highlighting as part of conduct risk their duties under Regulation Best Interest (Reg. BI) as well as fiduciary obligations under the US securities laws. Specifically, the Statement includes timely reminders for:

- Broker-dealers recommending LIBOR-linked securities
- Broker-dealers underwriting or recommending municipal securities
- Investment advisers recommending LIBOR-linked securities
- Funds and investment advisers investing in LIBOR-linked securities
- Companies and issuers of asset-backed securities making disclosures related to the LIBOR transition

Obligations for Broker-Dealers Under Reg. BI

According to the Statement, broker-dealers should be mindful of their obligations under Reg. BI when recommending LIBOR-linked securities to retail customers. Under Reg. BI's Duty of Care, "a broker-dealer must exercise reasonable diligence, care, and skill to, among other things, understand the potential risks, rewards, and costs associated with the recommendation."

In the Statement, SEC Staff emphasized that based on a fact-specific analysis broker-dealers must have a reasonable basis to believe that any recommendation they make involving LIBOR-linked securities is in their retail customers' best interests. According to SEC Staff, "reasonable diligence" may take into account client investment objectives, as well as the characteristics of the underlying securities such as complexity, risks, rewards, costs, liquidity, volatility, likely performance, expected return, associated incentives, etc.

The Statement clarifies that, to meet the Reg. BI Standard, broker-dealers must confirm whether a security has robust fallback language in its offering documents that clearly defines an alternative reference rate (ARR) to LIBOR. If a security does not have robust fallback language, then the recommendation must be "premised on a specific, identified, short-term trading objective." In

contrast, if a security does have robust fallback language, the broker-dealer must assess the impact the replacement rate will have on the expected performance of the security to determine whether the security is still in the customer's best interest.

Furthermore, under Reg. BI, broker-dealers that have agreed to perform monitoring services for a retail customer must reassess the potential risks, rewards, and costs of any LIBOR-linked security in their retail customer's account to ensure the investment is still in the customer's best interests. This obligation applies to buy, sell, or hold recommendations, and even when a broker-dealer remains silent (i.e., an implicit hold recommendation).

Obligations for Broker-Dealers Related to Municipal Securities

In addition to the Reg. BI standard for recommendations to retail customers, broker-dealers are subject to a few additional rules when recommending LIBOR-linked municipal securities.

1. Exchange Act Rule 15c2-12 requires broker-dealers to obtain and review a "deemed final" official statement by a municipal obligor. Per this rule, underwriters must have a reasonable basis to believe the key representations in the "deemed final" official statement are true. To meet this "reasonable basis" standard, broker-dealers underwriting municipal securities should review the municipal obligor's exposure to LIBOR-transition risks to ensure those risks are adequately addressed in the obligor's key representations.
2. Broker-dealers making recommendations to non-retail customers are subject to the suitability standard in MSRB Rule G-19. Accordingly, broker-dealers should consider a municipal obligor's exposure to LIBOR transition risks when making a suitability determination.
3. When broker-dealers sell or purchase municipal securities, MSRB Rule G-47 requires they disclose material information known or available to established industry sources regarding the municipal obligor's exposure to LIBOR transition risks.

Obligations for Registered Investment Advisers and Registered Funds

SEC-registered investment advisers must consider their fiduciary obligations under the Investment Advisers Act of 1940 when recommending LIBOR-linked securities and investment strategies. These fiduciary principles require advisers to consider whether LIBOR-linked investments are consistent with their client's goals. To do this, advisers must consider whether the investments or related contracts have robust fallback language providing a clear ARR. When an investment does include an ARR, advisers should consider whether those rates will cause the investment to depart from their client's goals or risk tolerance.

Funds and advisers should monitor and manage conflicts arising from the LIBOR transition. Specifically, advisers should make disclosures when the LIBOR transition impacts performance fees, which is likely for performance fees subject to a "hurdle rate" (the minimum return necessary for the adviser to start collecting the performance fee) that is tied to LIBOR.

LIBOR transition also implicates disclosure obligations for registered investment companies and business development companies to prevent misleading investors. Disclosures in offering documents for registered products must address the principal risks associated with the fund, including those related to the anticipated impact of LIBOR transition, if a fund invests a significant portion of its assets in LIBOR-linked investments.

Funds and advisers should also consider the impact the transition will have on valuation measurements that use LIBOR as an input, as well as the operational complexities that the LIBOR transition will introduce on their IT systems.

Obligations for Public Companies and Asset-Backed Securities Issuers

According to the Statement, public companies and asset-backed securities issuers should provide meaningful insight to investors about the status of their efforts to address LIBOR transition risks. Specifically, companies should provide material and specific qualitative and quantitative information to investors, “rather than general statements about the progress of the company’s transition efforts to date.” To aid these disclosure requirements, the Statement outlines several specific disclosure recommendations:

- Companies should generally disclose the steps they have taken to identify their LIBOR exposure, what the company has done thus far to mitigate LIBOR transition risks, and what steps remain to mitigate those risks.
- Companies with outstanding debt that lacks robust fallback provisions should disclose how much LIBOR-linked debt they will have outstanding after the cessation date and the steps the company is taking to mitigate the risks involved.
- Companies that include disclosures about the LIBOR transition in response to more than one disclosure requirement within a single filing should provide cross-references or otherwise connect the information to clarify for the investor the company’s LIBOR risk profile.
- Firms specifically subject to regulatory guidance (such as the joint statements issued by the [Board of Governors of the Federal Reserve System](#), the [Office of the Comptroller of the Currency](#), and the Federal Deposit Insurance Corporation; and the Federal Reserve Board backed [Alternative Reference Rates Committee](#)) recommending that they avoid entering into new contracts that reference LIBOR after December 31, 2021, should disclose the details of their transition efforts and the impact of these efforts on their company, in alignment with such guidance.

Key Takeaways

The Statement’s recommendations will be of particular interest to firms and individuals under the SEC’s remit, as they may be indicative of the Staff’s key regulatory and examination priorities. Since at least June 18, 2020, the SEC’s Division of Examinations has highlighted that LIBOR transition is a priority, including when it issued a Risk Alert on LIBOR transition preparedness (see this [Latham post](#) for more information). As the long-anticipated deadline for key LIBOR tenors approaches, regulated firms should be alert to their various disclosure obligations and obligations under the fiduciary rules and Reg. BI. Firms should prepare for compliance with these rules, specifically as they relate to LIBOR transition.

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