SEC Puts LIBOR Transition Testing in Focus: Latham & Watkins

In anticipation of LIBOR discontinuation, the SEC will begin examining transition progress.

Nearly a year after the US Securities and Exchange Commission's (SEC's) release of a Staff Statement on LIBOR Transition, the SEC's Office of Compliance Inspections and Examinations (OCIE) appears ready to shift from passively monitoring LIBOR-transition risks to actively testing SEC-registered firms on their progress. OCIE previously mentioned LIBOR transition as an area to watch in its 2020 Examination Priorities, noting that "OCIE will be reviewing firms' preparations and disclosures regarding their readiness, particularly in relation to the transition's effects on investors."

OCIE released its latest Risk Alert on June 18, 2020 (Examination Initiative: LIBOR Transition Preparedness). The Alert provides registrants with specific information about the scope and content of OCIE's upcoming LIBOR-transition examinations and information requests. SEC registrants, including investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents, and clearing agencies, may find the Alert helpful in reviewing and formulating their own plans and priorities.

Background

In its statement issued on July 12, 2019, the SEC noted that the risks associated with the transition away from LIBOR "will be exacerbated if the work necessary to effect an orderly transition to an alternative reference rate is not completed in a timely manner." To that end, the SEC affirmed that it was "actively monitoring the extent to which market participants are identifying and addressing" LIBOR-transition risks.

Planning Is Good, Progress Is Better

OCIE intends to review the extent to which registrants have evaluated the potential internal and external impacts of transitioning away from LIBOR, specifically as they relate to a firm's:

- Business activities
- Operations
- Services
- Customers, clients, or investors

Specifically, OCIE will review registrants' plans and progress with regards to:

- **Inventory:** Assessment of exposure to LIBOR-linked contracts with maturities beyond the expected discontinuation date of end-2021
- **Fallbacks**: Implementation of fallback language into impacted contracts
- **Operational readiness:** Enhancements or modifications to systems, controls, processes, and risk or valuation models

- **Communications:** Disclosures, representations, and reporting to investors regarding LIBOR transition efforts
- **Conflicts:** Identification and remediation of any potential conflicts of interest arising from LIBOR transition
- **Clients' efforts:** Clients' efforts to employ appropriate alternative reference rates

Appended to the Alert is an extensive (although not exclusive) list of potential documents and categories of information that OCIE may request from registrants during LIBOR transition examinations. While examinations may vary depending on the facts and circumstances of each registrant, requests for information may relate to:

- Organizational structure, particularly as it may be impacted by LIBOR transition
- Individuals or committees responsible for LIBOR transition oversight, and their related activities
- Impact assessments and results
- Strategic plans and timelines
- Risk management documentation
- Impacted risk and valuation models
- Communication made both externally to clients and internally to management, employees, or supervised persons
- Third parties or vendors that may be impacted by the transition away from LIBOR, or that a registrant may have employed to assist with LIBOR transition

Implications

Market participants have long been aware that the discontinuation of LIBOR would pose a complex set of operational challenges. The intervening COVID-19 pandemic, however, undoubtedly diverted resources and attention away from execution of LIBOR transition plans. Market participants, however, should keep LIBOR transition in focus and continue to address the array of challenges it presents, as regulatory authorities across the globe have communicated that LIBOR discontinuation remains on track.

On March 25, 2020, the UK Financial Conduct Authority (FCA), Bank of England, and members of the Sterling RFR Working Group issued a statement on the impact of COVID-19 on firms' LIBOR transition planning. The UK authorities acknowledged in that statement that COVID-19 had impacted the timing of some aspects of the transition programs, but confirmed that there is no change to the assumption that firms cannot rely on LIBOR being published after the end of 2021. The UK authorities reconfirmed this assumption on April 29, 2020. Subsequently, on May 13, 2020, the UK Prudential Regulation Authority (PRA) and FCA announced a resumption of full supervisory engagement with firms on their LIBOR transition progress beginning June 1, 2020, including data reporting at the end of Q2 (previously suspended at the end of Q1 due to the COVID-19 pandemic).

In its 2020 Examination Priorities, OCIE warned that "insufficient preparation could cause harm to retail investors and significant legal and compliance, economic and operational risks for registrants." Regulatory risk can be added to that list, as OCIE begins to incorporate LIBOR-transition readiness into its examinations. Registrants must now be prepared to evidence their transition efforts in preparing for the scheduled discontinuation of LIBOR.

For more information on LIBOR transition issues, see:

[10 LIBOR Transition Focus Areas in 2020]

[LIBOR Discontinuation and Transition — What Investment Managers Should Know]

FCA Indicates LIBOR Transition Deadline Will Not Be Extended Due to COVID-19

HM Treasury Announces Welcome Proposed Amendments to the UK Benchmarks Regulation

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