Bond Case Briefs

Municipal Finance Law Since 1971

SEC Publishes OCIE Risk Alert on LIBOR Transition Preparedness Examination Initiative: Dechert

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations issued a National Exam Program Risk Alert on June 18, 2020 (Risk Alert),1 which introduces an examination initiative on the upcoming discontinuation of, and transition from, LIBOR2 to alternative risk-free reference rates (widely referred to as RFRs) (LIBOR Transition). The Risk Alert states that the examination initiative (LIBOR Exams), which has commenced recently, is intended to allow OCIE to assess the preparedness of SEC-registered investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies (collectively, Registrants) that may be impacted by the LIBOR Transition. The Risk Alert includes a sample list of documents that may be requested in a LIBOR Exam and is intended to assist Registrants with their preparations.

This Dechert OnPoint provides general background regarding LIBOR and the LIBOR Transition, describes key points for Registrants impacted by the LIBOR Transition or who are the recipients of a related examination request, and offers next steps that Registrants can consider in their LIBOR Transition preparations. Dechert has tracked developments related to LIBOR and the LIBOR Transition – for further information, please refer to Preparing for the Replacement of LIBOR.

Background on LIBOR

On any given day, LIBOR is calculated across seven tenors for each of five currencies (USD, GBP, CHF, EUR and JPY). LIBOR is intended to be a measure, for each currency and tenor, of the average rate at which leading internationally active banks are willing to borrow wholesale, unsecured funds in the London interbank market.3 LIBOR and other interbank offered rates (IBORs) are global, long-standing and extensively used benchmarks or reference rates (reference rates) for determining interest rates in contracts related to financial transactions, adjustable-rate financial products and derivatives.4

In July 2017, Andrew Bailey, then-Chief Executive of the UK Financial Conduct Authority (FCA), announced that the FCA would no longer persuade or compel LIBOR panel banks to continue to make LIBOR data submissions after 2021.5 As a result, it is currently expected that around January 1, 2022, LIBOR will cease publication or will no longer be sufficiently robust or reliable to be representative of its underlying market.6 It follows that LIBOR (and most other IBORs) then will cease to be effective reference rates for financial transactions and other contractual arrangements.

Following Mr. Bailey's 2017 announcement, working groups began to plan in earnest for the eventual unavailability of LIBOR and other IBORs throughout the world. Each of these working groups aimed to identify and recommend alternative RFRs denominated in the relevant local currency. Since reference rates serve a critical commercial function, any alternative to LIBOR will need to be commercially similar in a variety of respects in order to assure consistent adoption by the financial community.7 It is expected that the majority of LIBOR (and other IBOR) replacements will

be derived from RFRs developed by these working groups.

In the United States, the Federal Reserve Board and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC), a working group of private-sector representatives and financial regulators, to recommend an alternative reference rate to USD LIBOR. The ARRC recommended the Secured Overnight Financing Rate (SOFR)8 as its preferred alternative reference rate. Launched in April 2018, SOFR is based on the cost of overnight loans, using repurchase agreements secured by U.S. government securities (which represents a larger section of transactions than is used to derive the Fed Funds rate). However, at this time, SOFR is not widely used as a reference rate. As LIBOR may become unavailable to be used in contracts in 2022, the timeline for the transition to using SOFR as the reference rate for USD LIBOR will be highly compressed. The ARRC and similar working groups are continuing their work on LIBOR replacement solutions.

Practically, transitioning to a new reference rate is not a flip-of-the-switch event, and the current timeline only emphasizes the need for a transition plan. Given the widespread use of LIBOR as a reference rate in common commercial arrangements, the LIBOR Transition no doubt will have a significant and broad-reaching impact on many Registrants (including their business activities, operations and service provider relationships). Based upon a Registrant's business model, the Registrant will need to implement LIBOR Transition solutions (such as those recommended by the ARRC or other similar working groups) in a manner appropriate to its businesses and operations.

In light of the commercial importance of LIBOR and other IBORs, coverage in the financial press has been widespread, and issues related to LIBOR and its expected discontinuation are high on regulatory agendas worldwide.9 Financial services regulators – including the staffs of OCIE and various other SEC divisions and offices – have repeatedly emphasized the importance of Registrants' careful and considered preparation for the LIBOR Transition.10 In addition, the LIBOR Transition is listed as one of OCIE's 2020 examination priority "risk themes" that would be used to "tailor its risk-based program" this year.11 Consistent with those messages, the Risk Alert further emphasizes the importance of Registrants' preparations, and provides OCIE's views regarding the preparations required for a Registrant to effect an orderly transition away from LIBOR.

Risk Alert

The Risk Alert describes the "scope and content" for a series of risk-based examinations (often referred to as "sweep exams") that will focus on Registrants' preparedness for the LIBOR Transition.12 The Risk Alert further emphasizes the theme of preparedness and provides some insight into what OCIE staff may view as steps Registrants could take in anticipation of the LIBOR Transition. The Risk Alert states OCIE's view that "[p]reparation for the transition away from LIBOR is essential for minimizing any potential adverse effects associated with LIBOR discontinuation" and that the "risks associated with this discontinuation and transition will be exacerbated if the work necessary to effect an orderly transition to an alternative reference rate is not completed in a timely manner." As such, OCIE staff stresses that the LIBOR Exams are intended to "help promote and facilitate an orderly discontinuation … and transition."

Examinations

Consistent with the above themes, the Risk Alert states that LIBOR Exams will assess (among other matters) "whether and how the registrant has evaluated the potential impact of the LIBOR transition on the organization's: (i) business activities; (ii) operations; (iii) services; and (iv) customers, clients, and/or investors" (collectively, investors). By way of example, the Risk Alert states that OCIE will seek to review the Registrant's preparation, plans and actions related to the LIBOR Transition,

which could include an evaluation of:

- *Exposure to LIBOR and mitigation efforts.* OCIE will seek to understand and evaluate, to the extent relevant, the exposure of the Registrant and its investors to contracts that use LIBOR as a reference rate beyond the expected LIBOR Transition date, "including any fallback language incorporated into these contracts";
- *Operational readiness for LIBOR Transition.* OCIE will review and evaluate enhancements or modifications the Registrant has made to its "systems, controls, processes, and risk or valuation models" in connection with the LIBOR Transition to a new reference rate;
- *Investor communications relating to the LIBOR Transition.* OCIE will examine the Registrant's "disclosures, representations, and/or reporting to investors regarding its efforts to address LIBOR discontinuation and the adoption of alternative reference rates";
- *Potential conflicts of interest.* OCIE will seek to understand and evaluate the Registrant's identification and mitigation of "any potential conflicts of interest" related to the LIBOR Transition; and
- *Efforts to replace LIBOR.* OCIE will examine the Registrant's actions taken to transition to an "appropriate alternative reference rate."***Sample Document Request List***

The Risk Alert states that the sample document request list included in the Risk Alert is intended to "empower compliance professionals" to assess and assist with Registrants' preparedness for the LIBOR Transition. While this list is a "resource" for Registrants to consult, it is not "all-inclusive" or "specifically indicative of the validation and testing" OCIE could perform. Thus, an actual document request list received by a Registrant is likely to vary based on the facts and circumstances. The Risk Alert also references the OCIE staff's potential "review [of] certain information onsite."

The types of documents set forth in the document request list can be broadly categorized as pertaining to:

- *Organizational structure and management.* This consists of information identifying aspects of a Registrant that might be impacted by the LIBOR Transition, as well as the personnel responsible for assessing, overseeing and managing LIBOR Transition efforts, including any third parties, and documentary evidence of the same (e.g., meeting minutes).
- *Assessment and management of LIBOR exposure.* This is documentation identifying: (i) potentially affected contracts or obligations of the Registrant or its investors, performance composites or advertisements, LIBOR-based models (e.g., risk, valuation), and investors (e.g., fee structures, performance reporting); (ii) the related underlying documents; and (iii) information regarding dependence on third-party service providers and the potential impact on their services. This also includes strategic plans or timelines for remediation, and any risk matrices "that reference" the LIBOR Transition.
- *Disclosures to stakeholders.* This includes information provided to governing bodies and filed with the SEC.13
- *Guidance provided by the Registrant to its employees or supervised persons regarding recommendations or advice to investors, issuers or clients.* This includes: recommendations to investors regarding "LIBOR-linked instruments or contracts that extend past the current expected discontinuation date, reviews of portfolios containing such instruments, or the underwriting of new instruments referencing LIBOR"; advice to issuers as to "new LIBOR-linked instruments"; and advice to clients regarding outstanding contracts or obligations that replace LIBOR with an appropriate reference rate.
- *Modifications to operations or compliance programs made or anticipated.* This includes planned or implemented changes to various systems (e.g., "accounting, investor reporting, risk, valuation or trading") and "compliance procedures, controls, or surveillance systems."***Resources to Aid***

Registrants with the LIBOR Transition

The Risk Alert encourages continued engagement by: suggesting that Registrants' personnel keep up-to-date on developments related to the LIBOR Transition via the AARC website; and inviting "the public to share information about the potential impact" of the LIBOR Transition via LIBOR@sec.gov.

Implications for U.S. and Non-U.S. Registrants

While the Risk Alert is the statement of one office of one regulator regarding how to prepare for the LIBOR Transition, its message should resonate across all market participants and jurisdictions. The message is consistent with statements from other regulators internationally: the issue of LIBOR Transition is not going away, and it is now time for Registrants and other market participants to focus on preparations for the LIBOR Transition. The Risk Alert is a signal that Registrants and other market participants are expected to be preparing for the transition from LIBOR and other IBORs. As indicated by the document request list, Registrants can begin by evaluating the potential impact of the LIBOR Transition on their businesses and operations, with a view toward implementing solutions that are appropriate in light of their exposure to LIBOR or other IBORs.

Regardless of a Registrant's state of preparation, the Risk Alert can prove valuable in helping Registrants better understand OCIE's view as to the type of preparations that could best effectuate an orderly transition. Registrants at the beginning stages of preparedness can use the Risk Alert to assess the scale and scope of the Registrant's current exposure to LIBOR, as well as a road map for managing an orderly LIBOR Transition. Registrants that are further down the road might view the Risk Alert as a checklist to assess their own progress. The Risk Alert (in particular, the sample document request list) also could be instructive to Registrants and other market participants in determining key documents that might be useful in identifying and managing any emerging risks across their businesses, and engaging and sharing information with various stakeholders about those risks and the Registrant's efforts to manage and/or mitigate them.

Dechert LLP – Philip T. Hinkle, Michael L. Sherman, Jonathan D. Gaynor, Ashley N. Rodriguez and Karen Stretch

July 30 2020

Dechert's Financial Services and Finance and Real Estate practice groups have significant experience and are available to assist firms on a collaborative basis to address concerns related to the LIBOR Transition, including guiding a Registrant through any SEC examinations.

Footnotes

1) Examination Initiative: LIBOR Transition Preparedness, National Exam Program Risk Alert, U.S. SEC Office of Compliance Inspections and Examinations (June 18, 2020). The Risk Alert indicates that it "has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person."

2) LIBOR also is referred to as ICE LIBOR and formerly as the London Interbank Offered Rate.

3) The methodologies used to determine LIBOR for a particular currency and tenor are based on submissions made by panel banks to the LIBOR benchmark administrator, ICE Benchmark Administration Limited (IBA), each London business day. The methodologies and panel banks per currency and tenor used are listed on IBA's webpage. As a UK-based benchmark administrator, IBA is regulated by the UK's Financial Conduct Authority.

4) Libor: Entering the Endgame, Andrew Bailey, Governor of the Bank of England (July, 13, 2020) (including an indication that LIBOR rates directly impact the cash flows and values of an estimated $400 trillion of financial products globally).

5) The Future of LIBOR, Andrew Bailey, then-Chief Executive of the FCA (July, 27 2017).

6) Panel banks have agreed to continue submitting the relevant data through 2021. However, absent an active market for unsecured term lending to banks, the FCA has determined not to compel banks to provide this information after 2021. The limitations of LIBOR as a reference rate have been widely reported, and the July 2020 speech by Andrew Bailey (footnote 4 supra) includes a discussion of this topic.
More generally, and historically, regulatory investigations in Europe and the United States following the 2007-2008 financial crisis revealed that for some years, both preceding and during the financial crisis, the volume of transactions in the interbank markets of the relevant currencies had decreased significantly. It was determined that the panel banks that contribute to the production of LIBOR were relying on their expert judgment, rather than observable market rates, for some of their submissions, and in many cases were manipulating their submissions to the benchmark administrator and, thus, manipulating LIBOR for certain tenors and currencies.

7) RFRs generally measure market rates for secured overnight borrowing. RFRs do not purport to capture the sort of counterparty credit risk or term component that may be represented in unsecured term borrowing rates, like LIBOR or other IBORs; thus, a spread adjustment would be needed for an RFR to serve as a commercially practical replacement reference rate for LIBOR or other IBORs.

8) SOFR and the SOFR Averages are published by the Federal Reserve Bank of New York.

9) For example, regulatory investigations in Europe and the United States following the 2007-2008 global financial crisis revealed that for some years, both preceding and during the financial crisis, the volume of transactions in the interbank markets of the relevant currencies had decreased significantly. It was determined that the panel banks that contribute to the production of LIBOR were relying on their expert judgment, rather than observable market rates, for some of their submissions, and in some cases were seen as manipulating their submissions to the benchmark administrator (and, thus, manipulating LIBOR for certain tenors and currencies).

10) For example, see SEC Public Statement, Staff Statement on LIBOR Transition (July 12, 2019); for further information, please refer to Dechert OnPoint, SEC Staff Issues Statement on LIBOR Transition; Practical Considerations for Investment Companies, Investment Advisers and Other Financial Institutions in Proactively Addressing LIBOR Cessation and Transition.

11) 2020 Examination Priorities, U.S. Office of Compliance Inspections and Examinations (Jan. 7, 2020) ("The risk-based approach, both in selecting registrants as examination candidates and in scoping risk areas to examine, provides OCIE with greater flexibility to cover emerging and exigent risks to investors and the marketplace as they arise. For example, as our registrants and other market participants transition away from LIBOR as a widely used reference rate in a number of financial instruments to an alternative reference rate, OCIE will be reviewing firms' preparations and disclosures regarding their readiness, particularly in relation to the transition's effects on investors. Some registrants have already begun this effort and OCIE encourages each registrant to evaluate its organization's and clients' exposure to LIBOR, not just in the context of fallback language in contracts, but its use in benchmarks and indices; accounting systems; risk models; and client reporting, among other areas. Insufficient preparation could cause harm to retail investors and significant legal and compliance, economic and operational risks for registrants"). For further

information, please refer to Dechert OnPoint, OCIE Releases 2020 Examination Priorities.

12) Typically, the federal securities laws subject Registrants (and those required to be registered) to examination by the SEC. The SEC views examinations as a front-line means to protect investors and ensure compliance with the federal securities laws. Sweep examinations are focused on identified risks, and these examinations tend not to be as broad as routine examinations of Registrants.

13) The sample document request list indicates that the relevant period for filings with the SEC is from January 2019 to present.

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com