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FINRA Issues Guidance to Help Firms Prepare for LIBOR Transition: McGuireWoods

On August 5, 2020, FINRA issued a regulatory notice outlining steps for broker-dealers to prepare for the pending transition away from LIBOR. The notice reminds firms to "evaluate their exposure to LIBOR" and "review their preparedness to manage LIBOR's phase-out." While the notice expressly disclaims any agency view of "specific effective practices," it provides questions for firms to consider and a general description of best practices, which derive from responses to a survey undertaken by FINRA of a cross-section of member firms.

The survey found that, while large broker-dealers, especially those affiliated with large bank holding companies, had implemented extensive programs to prepare for the LIBOR transition, many other FINRA members had implemented only limited efforts. To help these firms prepare, FINRA shared practices relating to the following categories of preparedness:

- Governance Framework: Not surprisingly, as with any large-scale change event affecting the industry, FINRA found that many firms have prepared for the transition by implementing governance frameworks to manage the LIBOR phase-out. These firms will assign organizational responsibility for preparing for and managing the transition and developing "comprehensive phase-out plans," including identifying process changes, setting timelines, and tracking progress.
- **Financial Risk:** FINRA also found that firms are evaluating their financial risk by identifying their inventory of products and contracts maturing or rolling over after the phase-out to estimate the exposure of the firm and its customers.
- **Operational Risk:** FINRA found that firms are evaluating their operational risk by identifying "business processes, business units, information systems and vendors that would be impacted by the phase-out" and by testing the firm's market, credit, and liquidity models with appropriate new reference rate(s).
- **Alternative Reference Rates:** FINRA found that firms have "reviewed and identified options" for alternative reference rates to replace LIBOR, including by participating in, or following the work of, industry organizations.
- **Legal Risk:** FINRA found that firms are reviewing their exposure to legal risk by identifying all existing contracts impacted by the phase-out and reviewing or developing fallback language. In some cases, this may include renegotiating contracts to account for the transition and replacement with alternative rates.
- **Staff Training and Customer Education:** Finally, FINRA found that firms have prepared by providing education and guidance to their staff, customers, and counterparties, including by developing "centralized" resources and guidance for staff and by "providing disclosures on firm websites and customer communications" about the phase-out's impact on the firm's customers and its products.

We can expect more information from FINRA between now and leading up to the transition deadline. As FINRA stated in its 2020 Risk Monitoring and Examination Priorities Letter, in highlighting their continued efforts to "explore new ways to expand our dialogue with firms about risks and trends facing the industry," it intends to engage with firms outside the examination program in order to understand how firms are preparing for the LIBOR transition. FINRA has used this approach to understand other issues with significant impact on the industry and shared its findings in the form of notices and reports to assist other firms in meeting the challenges. Additionally, the 2020 Letter emphasized FINRA's intent to assess the transition impact on customers, in addition to assessing risk and exposure to LIBOR-linked products.

FINRA's notice follows the [June 18, 2020, SEC Risk Alert] announcing that its Office of Compliance Inspections & Examinations ("OCIE") had identified registrant preparedness for the LIBOR transition as an examination priority for fiscal year 2020. OCIE stated that it "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." These examinations will review, among other items, exposure of firms and their investors to LIBOR-linked contracts, "operational readiness" to manage the transition, and firms' disclosures and representations to investors regarding their "efforts to address LIBOR discontinuation and the adoption of alternative reference rates."

The SEC also highlighted the LIBOR transition in its 2020 examination priorities alert. OCIE noted that the examination staff, along with other SEC Divisions and Offices, would engage with firms to assess the impact the transition would have on risk and compliance challenges. OCIE also highlighted that they would pay particular attention to disclosure issues "regarding [firms'] readiness, particularly in relation to the transition's effects on investors." OCIE concluded by encouraging "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."

These communications highlight the extensive attention given by the federal government and financial regulators to ensuring industry's proactive preparedness for the LIBOR transition and its consequences. We can expect to see further alerts from both regulators throughout the rest of 2020 and in 2021 as they share what they have learned from their engagement with the industry about what has worked and not worked for firms in preparing for the end of reliance on the LIBOR standard.

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