HAWKINS ADVISORY

FEDERAL RESERVE REGULATION ZZ IMPLEMENTING THE ADJUSTABLE INTEREST RATE (LIBOR) ACT

The Federal Reserve System Board of Governors (the "Federal Reserve") wrapped up an eventful 2022 with a gift of clarity for those concerned with the mechanics of converting United States dollar denominated London Interbank Offered Rate-based interest rate calculations to rely instead on the Secured Overnight Financing Rate (respectively, "USD LIBOR" and "SOFR"). Regulation ZZ, implementing the Adjustable Interest Rate (LIBOR) Act (respectively, the "Regulation" and the "Federal LIBOR Act") will become effective on February 27, 2023.[1,2] Market participants who are parties to the "tough legacy contracts" that the Regulation addresses will have less than five months to voluntarily convert them to SOFR based rate-setting in reliance upon the Federal LIBOR Act's safe harbor and preemption provisions and the Regulation prior to the currently scheduled end of reliable USD LIBOR publication on June 30, 2023 ("Scheduled USD LIBOR Termination"). After that, rate-setting under remaining "tough legacy contracts" is expected to be automatically converted to utilize SOFR-based replacement benchmarks by operation of the Federal LIBOR Act and the Regulation. The Federal LIBOR Act was discussed in our March 23, 2022 *Hawkins Advisory* (Federal Legislation Moves SOFR Closer | Hawkins Delafield & Wood LLP). This *Advisory* updates that discussion to reflect Regulation ZZ.

Board-Selected Benchmark Replacements. The Federal LIBOR Act delegated to the Federal Reserve the task of determining SOFR-based "Board-Selected Benchmark Replacements" for various categories of "tough legacy contracts", which both have terms extending beyond Scheduled USD LIBOR Termination and do not contain adequate fallback provisions that would permit the parties to permanently replace USD LIBOR without relying either upon any form of USD LIBOR or upon another inquiry-based method to determine interbank lending or deposit rates.[3] Under the Federal LIBOR Act's by-operation-of-law backstop provisions, the Board-Selected Benchmark Replacements are to act as the replacement reference rates for tough legacy contracts upon Scheduled USD LIBOR Termination, unless the parties have opted out of its provisions.[4,5] In addition, the Federal LIBOR Act's safe harbor and preemption provisions apply to protect earlier adopters of Board-Selected Benchmark Replacements against a variety of legal risks.[6]

The Regulation separately establishes Board-Selected Benchmark Replacements for six contract categories:[7]

1. for derivative transactions, the Board-Selected Benchmark Replacement will be "Fallback Rate (SOFR)", as provided in the International Swaps and Derivatives Association 2020 IBOR Fallbacks Protocol (the "ISDA Fallbacks Protocol"),[8] which includes a reference to a spread component that the Regulation recognizes to be equal to the statutorily prescribed tenor spread adjustments for different rate-setting tenors ("Tenor Spread Adjustments");[9]

2. for other contracts that are not treated as special cases, as described in paragraphs three through six below, the Board-Selected Benchmark Replacement will be: (a) SOFR, for daily tenor rate-setting; or (b) the applicable CME Term SOFR Reference Rate, as published by the CME Group Benchmark Administration, Ltd. (or any successor administrator) ("CME Term SOFR"), for other contractual rate-setting tenors, in each case, plus the applicable Tenor Spread Adjustment;

1 Federal Reserve Bank; Regulation Implementing the Adjustable Interest Rate (LIBOR) Act (Regulation ZZ), codified at 12 C.F.R. Part 253, 88 Fed. Reg. 5204 (F.R. Document 2023-00213) (hereinafter "Regulation ZZ").

2 Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103 div. U, (2022), (codified at 12 USC 5801 et seq., 15 USC 77ppp(b)(3) and 20 USC 1087-1(b)(2)(I)(viii) (hereinafter "Federal LIBOR Act").

3 Federal LIBOR Act §§ 103(16) and 104(a), 12 USC 5802(16) and 5803(a).

4 Parties considering opting out of the Federal LIBOR Act provisions should also consider the need to opt out of any applicable state or local law requirements that might apply to LIBOR termination or benchmark substitution and would otherwise be preempted by the Federal LIBOR Act, if that is permitted, or to comply with such requirements.

5 Federal LIBOR Act § 104(b), (codified at 12 USC 5803(b)). Absent further Federal Reserve action, the LIBOR Replacement Date will be the first London banking day after June 30, 2023. See (Federal Legislation Moves SOFR Closer, Hawkins Delafield & Wood LLP), text at footnotes 10-11.

6 Federal LIBOR Act §§ 104(c), 105 and 107, (codified at 12 USC 5803(c), 5804 and 5806).

7 Regulation ZZ § 253.4.

8 ISDA; ISDA 2020 IBOR Fallbacks Protocol, Oct. 23, 2020, available at http://assets.isda.org/media/3062e7b4/08268161-pdf/. (last visited January 26, 2023). The principal difference between the form of Regulation ZZ posted by the Federal Reserve on its website on December 16, 2022 and its final form is the inclusion of the full text of the ISDA Fallbacks Protocol as an appendix. This is intended to be for ease of reference, rather than a substantive change. See 88 Fed. Reg. 5208.

9 Federal LIBOR Act § 103(20), (codified at 12 USC 5802(20)).

3. for consumer loans, the Board-Selected Benchmark Replacement will be: (a) SOFR, for daily tenor rate-setting; or (b) the applicable CME Term SOFR, for other contractual rate-setting tenors, in each case, plus an adjustment factor that shall initially be the difference between: (x) SOFR or the applicable CME Term SOFR value; and (y) the applicable USD LIBOR value on the day before the applicable replacement date and shall transition linearly to the applicable Tenor Spread Adjustment over the year from and including the replacement date;[10]
4. for Federal Home Loan Bank advances, the Board-Selected Benchmark Replacement will be Fallback Rate SOFR;
5. for other contracts involving entities regulated by the Federal Housing Finance Agency, the Board-Selected Benchmark Replacement will be: (a) SOFR, for daily tenor rate-setting; or (b) the 30-calendar-day compounded average of SOFR, as published by the Federal Reserve Bank of New York (or any successor administrator) (respectively,"30-day Average SOFR" and the "New York Fed"), for other contractual rate-setting tenors, in each case, plus the applicable Tenor Spread Adjustment;
6. for asset-backed securities with collateral pools, over 50% of which consist of Federal Family Education Loan Program loans as of the replacement date ("FFELP ABS"), the Board-Selected Benchmark Replacement will be: (a) the 90-calendar-day compounded average of SOFR, as published by the New York Fed, for three-month tenor rate-setting; or (b) 30-day Average SOFR, for other contractual rate-setting tenors, in each case, plus the applicable Tenor Spread Adjustment.

The final form of the Regulation differs materially from its initially proposed form with respect to contracts described in paragraphs four and six in response to comments received requesting changes. Hawkins assisted the Education Finance Council in connection with the development of the Federal LIBOR Act and the Regulation provisions relating to FFELP ABS.[11]

The Tenor Spread Adjustments were originally determined, as of March 5, 2021, for use in connection with the ISDA Fallbacks Protocol and were subsequently incorporated into the Federal LIBOR Act. The Regulation Adopting Release states that the Federal LIBOR Act did not authorize the Federal Reserve to modify or alter these adjustments in response to comments requesting this.[12] Accordingly, the Tenor Spread Adjustments may be expected to remain static, despite changes in market conditions since their determination date.

Benchmark Replacement Conforming Changes. The Federal LIBOR Act charged the Federal Reserve with promulgating regulations to carry out its provisions, including by specifying "Benchmark Replacement Conforming Changes" affecting the implementation, administration and calculation of Board-Selected Benchmark Replacements that would be statutorily deemed to become an integral part of contracts without the need for other amendment or consent upon a voluntary or automatic replacement of USD LIBOR with a Board-Selected Benchmark Replacement.[13] The Federal LIBOR Act's safe harbor and preemptive provisions extend to these Benchmark Replacement Conforming Changes.[14] The Regulation specifies several Benchmark Replacement Conforming Changes that establish operational details affecting the timing and manner of rate determination utilizing a Board-Selected Benchmark Replacement, including that mid-interest period benchmark replacement will result in the use of LIBOR-based rates up to, but not including, the applicable replacement date and of the Board-Selected Benchmark Replacement thereafter,[15] while reserving the possibility that additional Benchmark Replacement Conforming Changes may be adopted.[16] In addition, the Regulation clarifies that a person who would be authorized under a "tough legacy contract" to act unilaterally to determine a benchmark replacement upon the occurrence of a contingency will be protected by the Federal LIBOR Act safe harbor provisions if acting to adopt a Board-Selected Benchmark Replacement without waiting for the contingency to occur, and that persons who currently are, or who may or will become, so authorized will be covered by the statutory safe harbor provisions, but only if authorized to act unilaterally.[17]

Status of Other Guidance. The Treasury guidance with respect to the federal tax treatment of reference rate substitution to eliminate USD LIBOR dependence that was discussed in prior Hawkins Advisories (Guidance from Treasury regarding USD LIBOR Phase-Out | Hawkins Delafield & Wood LLP and Final Treasury Reissuance Regulations Addressing Modifications of Debt Instruments to Replace IBORs | Hawkins Delafield & Wood LLP) remains applicable.[18] State tax law treatment should be confirmed

[10] The Regulation clarifies that consumer lenders may rely upon rates published by Refinitiv Limited in applying the applicable Board-Selected Benchmark Replacement, including with respect to the phase-in of applicable Tenor Spread Adjustments.
[11] Federal LIBOR Act § 109, (codified at 20 USC 1087-1(b)(2)(I)(viii)) and Regulation ZZ §253.4(b)(4).
[12] Federal LIBOR Act § 103(20), (codified at 12 USC 5802(20)). See (Federal Legislation Moves SOFR Closer, Hawkins Delafield & Wood LLP), footnotes 2 and 9.
[13] Federal LIBOR Act §§ 103(4) and 104(d), (codified at 12 USC 5802(4) and 5803(d)) and Regulation ZZ §253.5(a)(1).
[14] Federal LIBOR Act §§ 105 and 107 (codified at 12 USC 5804 and 5806).
[15] Regulation ZZ § 253.5(b).
[16] Regulation ZZ § 253.5(a)(2).
[17] Regulation ZZ § 253.5(b).
[18] See (Federal Legislation Moves SOFR Closer, Hawkins Delafield & Wood LLP), text at footnote 26. Rev. Proc. 2020-43, 2020-45 I.R.B. 991 related to contract modifications occurring prior to January 1, 2023.

by contracting parties on the basis of the specific facts affecting their contracts and contractual interests. On December 21, 2022, the Financial Accounting Standards Board extended through calendar year 2024 the previously established period of relief from certain contract modification related guidance and requirements with respect to modifications for the purpose of eliminating dependence upon USD LIBOR.[19]

* * *

Questions and comments may be addressed to Kenneth B. Roberts (kroberts@hawkins.com) or, with respect to tax treatment, to any of the Hawkins Delafield & Wood LLP tax attorneys listed below:

Ian Bearden	ibearden@hawkins.com
Jennifer B. Cordova	jcordova@hawkins.com
Michela Daliana	mdaliana@hawkins.com
Neil J. Kaplan	nkaplan@hawkins.com
Nicholas Koontz	nkoontz@hawkins.com
Russell A. Miller	rmiller@hawkins.com
Brian Organ	borgan@hawkins.com
Kathleen J. Orlandi	korlandi@hawkins.com
Zhujing Wu	zwu@hawkins.com

[19] *FASB, Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848, (December, 2022), available at: https://www.fasb.org/Page/ShowPdf?path=ASU+2022-06.pdf&title=ACCOUNTING+STANDARDS+UPDATE+2022-06%E2%80%94Reference+Rate+Reform+%28Topic+848%29%3A+Deferral+of+the+Sunset+Date+of+Topic+848&acceptedDisclaimer=true&Submit= (last visited January 26, 2023).*

New York
7 World Trade Center
250 Greenwich Street
New York, NY 10007
Tel: (212) 820-9300

Washington, D.C.
601 Thirteenth Street, N.W.
Washington, D.C. 20005
Tel: (202) 682-1480

Newark
One Gateway Center
Newark, NJ 07102
Tel: (973) 642-8584

Hartford
20 Church Street
Hartford, CT 06103
Tel: (860) 275-6260

Ann Arbor
201 S. Main Street
Ann Arbor, MI 48104
Tel: (734) 519-5003

Sacramento
1415 L Street
Sacramento, CA 95814
Tel: (916) 326-5200

Los Angeles
333 South Grand Avenue
Los Angeles, CA 90071
(213) 236-9050

San Francisco
One Embarcadero Center
San Francisco, CA 94111
Tel: (415) 486-4200

Portland
200 SW Market Street
Portland, OR 97201
Tel: (503) 402-1320

Raleigh
4801 Glenwood Avenue
Raleigh, NC 27612
Tel: (919) 635-8294

Hawkins
DELAFIELD & WOOD LLP