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The End of LIBOR: The Transition

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The collective staffs of the Securities and Exchange Commission's Divisions of Corporation Finance, Investment Management, and Trading and Markets and the Office of the Chief Accountant issued a joint statement on the significant impact that the expected discontinuation of LIBOR, the most widely used interest rate benchmark in the world, could have on the financial markets and the resultant material risk for certain market participants, including public companies, investment advisers, investment companies and broker-dealers. The key message from the SEC was 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.

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Pepper Hamilton previously provided background to the expected discontinuation of LIBOR in its August 24, 2017 Alert titled, "The 'End' of LIBOR: Considerations for Market Participants," (available at: https://www.pepperlaw.com/publications/the-end-of-libor-considerations-for-market-participants-2017-08-24/) and more recently discussed tax matters relevant to this item in its October 14, 2019 Alert titled, "Tax Relief May be Ahead for Market Participants Transitioning Away From LIBOR" (available at: https://www.pepperlaw.com/publications/tax-relief-may-be-ahead-for-market-participants-transitioning-away-from-libor-2019-10-14/).

LIBOR, the "world's most important number," is expected to be discontinued after 2021 due to many factors but, briefly, because LIBOR has become an unreliable benchmark for the global financial markets. Regulators worldwide have been working for many years to develop alternative benchmarks. Challenging differences exist between all alternative references rates being considered that will take time to resolve.

In the United States, the Alternative Reference Rates Committee (ARRC) — a group of private industry entities and official-sector entities, including the SEC, that was convened by the Federal Reserve Board and the New York Federal Reserve Bank to plan the market's transition away from U.S. dollar (USD) LIBOR — has selected SOFR (the Secured Overnight Financing Rate) as the preferred alternative rate for USD LIBOR. SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. SOFR is published by the Federal Reserve Bank of New York and is determined based on directly observable U.S. Treasury-backed repurchase transactions.

The SEC does not currently endorse the use of any one particular reference rate.

In its joint LIBOR statement, the SEC Staff encourages market participants that have not already done so to begin the process of identifying existing contracts that extend past 2021 to determine their exposure to LIBOR. Division-specific guidance was also issued in the joint LIBOR statement by each of the Staffs referenced above, detailing how the discontinuation of LIBOR may impact specific registrants and providing guidance on how the industry registrants under their purview might respond to this risk.

The Division of Investment Management addressed the impact that the expected discontinuation of LIBOR will have on investment companies and investment advisers, particularly those that invest in instruments referencing LIBOR, such as floating rate debt, bank loans, LIBOR-linked derivatives and certain asset-backed securities, and the functioning,

liquidity and value of these investments. The Division of Investment Management observes that the extent of this impact will depend on the specific types of investments, as well as the terms of those investments. The Division of Investment Management notes, for example, that investments without fallback language, or with fallback language that does not contemplate the discontinuation of LIBOR, could become less liquid and/or change in value as the date approaches when LIBOR will no longer be updated, or may contain interest rate provisions that may need to be renegotiated. The Division of Investment Management's guidance includes that investment companies should consider assessing any impact on the liquidity of their investments, including how those investments are classified and whether this could alter the effectiveness of their liquidity risk management programs, to ensure compliance with Rule 22e-4 under the Investment Company Act of 1940.

The Division of Investment Management noted that even investment companies that do not invest in instruments linked to LIBOR could be impacted by the discontinuation of LIBOR. For example, closed-end funds and business development companies that engage in direct lending may need to renegotiate the terms of contracts extending past 2021 that do not address the discontinuation of LIBOR. In addition, investment companies that have received exemptive orders that reference LIBOR (such as certain inter-fund lending orders) should consider evaluating possible implications for terms and conditions of their relief.

As always, disclosure is a key concern. The Division of Investment Management's guidance includes that investment companies and investment advisers should consider whether the impacts discussed above, and other consequences of the discontinuation of LIBOR, are risks that they should disclose to investors and how to provide investors with tailored risk disclosures that specifically describe the impact of the transition on their holdings. In relation to instruments extending past 2021 and referencing LIBOR, the Division of Investment Management's guidance includes that investment advisers should consider the effect the discontinuation of LIBOR will have on these instruments when recommending them to clients or monitoring them for clients.

If you have any questions about LIBOR or what the changes to LIBOR mean for you or your business, please contact the attorneys at Pepper Hamilton.

The SEC's Joint Staff Statement on LIBOR Transition is available at https://www.sec.gov/news/public-statement/libor-transition.