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LIBOR Discontinuation and Transition — What Investment Managers Should Know

The global shift away from LIBOR presents a complex, time-sensitive, multifaceted set of challenges and tasks for the investment management industry.

In a statement published on July 12, 2019, the US Securities and Exchange Commission (SEC) highlighted risks for market participants to consider as they transition away from the London Interbank Offered Rate (LIBOR). The SEC's statement encourages more proactive LIBOR transition and risk management by market participants.

As stated by SEC Chairman Jay Clayton, "The transition away from LIBOR is gaining some much-needed traction, but as the staff's statement makes clear, significant work remains ... The SEC will continue to monitor disclosure and risk management efforts related to the LIBOR transition."¹

This *Client Alert* highlights several key considerations for investment management firms and professionals as they develop plans to identify and address LIBOR transition issues.

Key Considerations for Investment Management Firms and Professionals

Background on LIBOR Transition

1. **LIBOR is expected to be phased out after 2021.** LIBOR is an interest rate benchmark used globally as a reference rate in connection with a wide range of investment management products and transactions, in addition to financial and corporate transactions. LIBOR is intended to reflect the rate at which major banks can obtain unsecured funding in a specific currency and for a specific term in the London interbank market. About US\$350 trillion worth of financial contracts currently reference LIBOR globally. LIBOR/IBOR rates are published in multiple currencies and for multiple time frames.
2. **The current expected LIBOR replacement appears to be SOFR.** In June 2017, the Alternative Reference Rates Committee (ARRC), a committee of financial market participants and other entities convened by the US Federal Reserve, chose the Secured Overnight Financing Rate (SOFR) as its preferred alternative to US Dollar LIBOR. SOFR is a broad measure of the cost of borrowing overnight collateralized by US Treasury securities.

3. **SOFR is different from LIBOR in material respects.** SOFR is an overnight, secured, nearly risk-free rate, whereas LIBOR is an unsecured inter-bank lending rate published for different maturities (e.g., overnight/spot, one week, one month, two months, three months, six months, and one year). SOFR is a broad measure of the cost of borrowing cash overnight collateralized by US Treasury securities involving a wider array of market participants. LIBOR is designed to reflect lending to prime banks and contemplates some credit risk. Thus, in transitioning index rates from LIBOR, interest rate mechanics and margins will likely need to be adjusted. Although some market participants have begun using SOFR as an alternative to LIBOR, the market is still working through the methodology of using SOFR. For example, “term SOFR” is not quoted currently, but is expected to be in the future.

Legacy and New Trades

4. **LIBOR Transition for Legacy Agreements.** Legacy contracts that reference LIBOR will need to be reviewed and possibly amended to reflect appropriate fallback and transition language. Considerations include:
 - Ability to amend legal documentation for existing transactions such as investment management contracts, provisions addressing interest on payments and fees; interest rate calculations on underlying portfolio loans, securities, derivatives, and hedging arrangements; investment fund leverage arrangements and subscription facilities, among others
 - Factors such as amendment provisions, consent and notice requirements, voting rights, “sacred rights” provisions that require 100% or other investor consents should be evaluated
 - Economic consequences and challenges, such as basis risk and margin adjustment
 - Identifying non-interest rate provisions linked to LIBOR, e.g., use of LIBOR to benchmark performance, spread and performance tests, determinations of the discount rate for make-whole provisions
 - Limits on fallback language in existing instruments if LIBOR/IBOR is no longer quoted or utilized by the market
 - Liability issues relating to rate changes and/or inability to determine or change rate basis
 - Potential tax issues
5. **LIBOR Transition for New Positions.** For new issuances, market participants should (especially if transactions will extend beyond 2021) include practical amendment language regarding the transition from LIBOR to an alternative benchmark or index rate and/or begin to adopt alternate reference rates and appropriate fallback language. Considerations include:
 - Negotiation and adequacy of fallback language
 - Risk factors and disclosures, if and when appropriate, regarding LIBOR transition and effects of LIBOR transition including in offering materials and Form ADV
 - Amendment provisions to address logistics for a global, market-wide shift

Action Items

6. Analysis of Investment Management Agreements, Duties, and Disclosures, including:

- Determining LIBOR utilization — survey documents for utilization, including fund agreements and related documents, separately managed accounts (SMAs), investment management agreements, and underlying investment product agreements
 - Example A: LIBOR-based interest rate on overdue and other payments owed to the investment manager
 - Example B: Benchmarks against which fund performance, etc., is measured, and underlying portfolio investment implications
- Authority for the investment manager to deal with LIBOR/IBOR replacement and investor and other party rights to consent, object, receive notice, etc.
- Investment manager contractual and fiduciary duty
- Potential conflicts of interest
- Exculpatory clauses in investment management agreements
- Offering and deal documents, risk factors, etc., including disclosure involving LIBOR transition, basis risk (e.g., any mismatch of interest rate on underlying portfolio investments versus fund liabilities in the case of structured products)
- ADV disclosure of LIBOR transition issues and risks for investment management clients when appropriate
- Determination of appropriate benchmark replacement risks and calculations thereof
- Documentation to implement change
- Potential valuation issues, basis exposure, repapering issues, and tax, and accounting issues
- Other implications, e.g., economic consequences, investor relations, notices, rating agencies, other parties involved, and contractual obligations

7. ARRC on Loans. In April 2019, the ARRC released its recommended US Dollar LIBOR fallback contract language for syndicated business loans, as it determined that more robust language was necessary. According to the ARRC, robust fallback language should include, in general terms:

- Well-defined trigger events (e.g., certain announcements regarding, or actual cessation of, LIBOR quotations) to signal conversion from LIBOR to a new reference rate (includes mandatory and “early opt-in” triggers)
- A successor rate (or successor rate waterfall), including how to calculate term “SOFR” in advance or SOFR compounded in arrears, if applicable, among others
- Spread adjustments to make the successor rate and LIBOR more comparable

- Lender consent process, if applicable

The language provides for either a “hardwired approach” or an “amendment approach” with the same mandatory fallback triggers. In the ARRC-recommended hardwired fallback language for syndicated loans, if a trigger event and its related effective date with respect to a benchmark occur, all references to the benchmark will be replaced throughout the documentation with the “Benchmark Replacement,” which encompasses the successor rate and any spread adjustment. The “amendment approach” does not prescribe what the successor rate or spread adjustment would be, but rather provides a streamlined amendment process for negotiating a benchmark replacement in the future. See Additional Recommended Resources below for further information.

8. **ARRC on Securitizations:** In May 2019, the ARRC released its recommended US Dollar LIBOR fallback contract language for securitizations, as it determined that more robust language was necessary. According to the ARRC, robust fallback language should include, in general terms:

- Well-defined trigger events to signal conversion from LIBOR to a new reference rate (includes mandatory and “early opt-in” triggers)
- A successor rate (or successor rate waterfall), including how to calculate term “SOFR” in advance or compounded in arrears, among others
- Spread adjustments to make the successor rate and LIBOR more comparable
- Relevant party consent process, if applicable

The language provides for either a “hardwired approach” or an “amendment approach” with the same mandatory fallback triggers. See Additional Recommended Resources below for further information.

9. **Derivatives Market Considerations.** The US Commodity Futures Trading Commission (CFTC) and the International Swaps and Derivatives Association (ISDA) have been focused on IBOR transition for the derivatives markets. A subcommittee of the CFTC Market Risk Advisory Committee is considering how and whether the CFTC should take any action in order to facilitate transition to SOFR. The subcommittee’s key areas of focus include: uncleared swap margin relief, a SOFR clearing mandate, and disclosure requirements. The subcommittee will issue final recommendations later this year.

At the request of the Financial Stability Board, industry bodies like ISDA and the Loan Syndications and Trading Association have been consulting with stakeholders regarding the LIBOR transition. ISDA efforts to facilitate a transition to SOFR include a benchmark supplement and post-cessation fallbacks, where ISDA will amend standard documentation to implement fallback reference rates for certain key IBORs if the relevant IBOR is permanently discontinued. For post-cessation fallbacks, ISDA has issued a consultation seeking input on preferred approaches for adjustments in addressing technical issues associated with fallbacks for IBORs. For pre-cessation fallbacks, ISDA has published a consultation seeking input on how derivatives contracts should address a regulatory announcement that LIBOR or certain other IBORs categorized as critical benchmarks under the EU Benchmarks Regulation are no longer representative of an underlying market. ISDA also intends to provide a protocol to amend legacy trades. However, amending legacy positions is challenging, because risk-free rates are structurally different than IBORs, and the risk profile and valuation of trillions of dollars of financial contracts will likely change. In addition, there are risks and difficulties involving valuation issues, basis exposure, repapering issues, and tax and accounting issues.

Additional Issues

10. **Other Things to Consider.** The transition from LIBOR to SOFR or another alternative reference rate can, depending on the degree of LIBOR-related touch points, require significant project management. Considerations include the scope of review and the potential use of AI for large-scale reviews, contractual analysis, and amendment implementation where needed, regulatory issues, reporting requirements, client disclosure and interaction, and scope of work, timing, and responsibility determinations. The LIBOR transition may also generate various sources of potential disputes and regulatory scrutiny, including:

- Financial reporting and disclosures to clients (risks relating to LIBOR transition, performance, and compensation) during and after transition
- Risk monitoring (models based on LIBOR inputs, impact on hedging, and hedge accounting)
- Transfer or loss of value on legacy contracts
- Conduct risk, including potential scrutiny of communications and trading activities

Conclusion

Given the upcoming expected cessation of LIBOR as a market benchmark at the end of 2021, regulators have been encouraging market participants to accelerate their transition planning and execution. As the above SEC Staff Statement highlights for the investment management industry, investment managers should consider the implications of LIBOR transition on their business in the near term, if they have not already.

Additional Recommended Resources

- [SEC Staff Statement on LIBOR Transition](#) (July 12, 2019). SEC Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets and Office of the Chief Accountant. The SEC staff published a statement that encourages market participants to proactively manage their transition away from LIBOR and outlines several potential areas that may warrant increased attention during that time.
- [The Alternative Reference Rates Committee Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans](#) (April 25, 2019). In accordance with the results of the ARRC's Consultations, the ARRC has published recommended fallback language for market participants to consider for new issuances of syndicated business loans referencing LIBOR.
- [The Alternative Reference Rates Committee Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations](#) (May 31, 2019). In accordance with the results of the ARRC's Consultations, the ARRC has published recommended fallback language for market participants to consider for new issuances of securitizations referencing LIBOR.
- [The Alternative Reference Rates Committee: A User's Guide to SOFR](#) (April 2019). This note is intended to help explain how market participants can use SOFR in cash products.

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Endnotes

¹ <https://www.sec.gov/news/press-release/2019-129>