

MEMO# 31855

July 15, 2019

SEC Staff Issues Statement on LIBOR Transition

[31855]

July 15, 2019 TO: ICI Members
Investment Company Directors
ICI Global Members
Accounting/Treasurers Committee
Chief Risk Officer Committee
Closed-End Investment Company Committee
Derivatives Markets Advisory Committee
Fixed-Income Advisory Committee
Internal Audit Committee
International Internal Audit Advisory Committee
Investment Advisers Committee
SEC Rules Committee
Small Funds Committee SUBJECTS: Compliance
Derivatives
Disclosure
Fixed Income Securities
Fund Accounting & Financial Reporting
International/Global
Investment Advisers
Operations
Risk Oversight
Systemic Risk
Tax
Trading and Markets
Valuation RE: SEC Staff Issues Statement on LIBOR Transition

Staff from the SEC's Division of Corporate Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant recently issued a statement about the potentially significant effects on financial markets and market participants when LIBOR is discontinued in 2021 and no longer available as a reference benchmark rate.[\[1\]](#)

The staff statement, which is summarized below, includes recommendations for all market participants to consider in assessing their exposure to LIBOR-related risks as well as

guidance from the staff of the Division of Investment Management for investment companies and advisers, and guidance from the staff of the Office of the Chief Accountant regarding accounting and financial reporting.^[2] The staff encourages market participants to begin managing their LIBOR transition now. As the staff states and Chairman Jay Clayton reiterates, “for many market participants, waiting until all open questions have been answered ... could prove to be too late to accomplish the challenging task required.”^[3]

Guidance for All Market Participants on LIBOR-Related Risks

The staff recommends several steps that all market participants, including investment companies, should consider taking to assess and mitigate the risks to their business strategy, products, processes, and information systems associated with LIBOR discontinuation.

First, the staff recommends that market participants identify and review any existing contracts, transactions, and instruments that extend past 2021 and that reference LIBOR. Notably, the staff advises market participants to consider whether any such contracts, either individually or in the aggregate, create exposures to risks that could be material to the market participant.

For existing contracts, the staff recommends that market participants determine if those contracts already contain fallback language for the benchmark rate and, if so, whether the fallback language anticipates LIBOR discontinuation. In addition, market participants should consider whether to negotiate an alternative reference rate to replace LIBOR in an existing contract. While noting that the SEC does not endorse the use of any particular alternative reference rate to replace LIBOR, the staff notes the work of the Alternative Reference Rate Committee (ARRC) in the United States to identify the Secured Overnight Financing Rate (SOFR) as its preferred alternative for USD LIBOR.^[4] However, as the staff notes, at this time, industry participants are still developing term rates for SOFR as well as the methodology to determine fair spreads between SOFR, a secured rate, and LIBOR, which incorporates credit risk. Thus, the staff recommends that market participants think about whether there are differences between LIBOR and any alternative reference rate – SOFR or others – that could impact the profitability or costs of an existing contract or introduce any new risks.

Before entering into new transactions, the staff recommends that market participants consider whether those contracts should reference an alternative rate to LIBOR, such as SOFR, or include fallback language that anticipates LIBOR discontinuation, as ARRC recommends for several types of contracts.^[5]

The staff also recommends that market participants identify and mitigate risks, such as financial, operational, legal, regulatory, or technology risks that may result from LIBOR discontinuation. Additionally, market participants should ensure that their information technology systems can accommodate any LIBOR replacement.

Guidance from Division of Investment Management Staff for Funds and Advisers

In addition to the general guidance discussed above, the Division of Investment Management staff identifies several issues that investment companies and advisers specifically may need to address in advance of LIBOR discontinuation.

First, the staff notes that funds that invest in instruments referencing LIBOR, including many derivatives and asset-based securities, should plan their response to any potential

changes to the liquidity and valuation of those instruments as LIBOR discontinuation approaches.^[6] Similarly, closed-end funds and BDCs that engage in direct lending referencing LIBOR should consider whether renegotiating the terms of those transactions will be necessary. Investment advisers should also consider the effect of LIBOR discontinuation on any instruments or products they recommend or monitor for their clients that extend past 2021.

Further, funds that rely on exemptive orders that reference LIBOR, including orders concerning interfund lending, should consider the impact of LIBOR discontinuation on their exemptive relief.

Funds and advisers also should consider carefully whether LIBOR discontinuation creates risks that should be disclosed to investors or clients. If so, the staff advises that generic disclosures about LIBOR are less helpful to investors and encourages tailored disclosures that are specific to the effect of LIBOR discontinuation on fund or client holdings.

Guidance from the Office of the Chief Accountant Staff

The staff of the Office of the Chief Accountant notes that transitioning from one benchmark rate to another can have effects on a company's financial reporting and accounting. The staff encourages accounting and financial reporting participants to be alert to LIBOR-related issues, including modifications of terms within debt instruments, hedging activities, inputs used in valuation models, and potential income tax consequences.

The staff also states that they are actively monitoring the activities of auditors and standard setters as the LIBOR discontinuation date approaches. With respect to the standard-setting work of the Financial Accounting Standards Board in particular, the staff notes that it has added a project to its agenda regarding LIBOR, and recently issued an Accounting Standards Update to allow for the Overnight Index Swap rate based on SOFR to be designated as a benchmark rate for hedge accounting.^[7] Similarly, the International Accounting Standards Board recently published an Exposure Draft, Interest Rate Benchmark Reform proposal to address hedge accounting issues.^[8]

Bridget Farrell
Assistant General Counsel

endnotes

^[1] See *Staff Statement on LIBOR Transition* (Jul. 12, 2019), available at <https://www.sec.gov/news/public-statement/libor-transition>. While the staff statement focuses on LIBOR, the staff urges market participants also to consider examining their exposures to other reference rates undergoing transitions.

^[2] In addition to the guidance provided by the staff of the Division of Investment Management and the Office of the Chief Accountant, staff from the Divisions of Corporation Finance and Trading and Markets also provide guidance on the effect of the discontinuation of LIBOR on specific registrants. The staff statement notes that registrants may find guidance provided by a division or office, other than the one they view as their primary staff contact, insightful and encourages registrants to evaluate the entire staff statement.

[3] See *SEC Staff Publishes Statement Highlighting Risks for Market Participants to Consider As They Transition Away from LIBOR* (Jul. 12, 2019), available at <https://www.sec.gov/news/press-release/2019-129>.

[4] SOFR is a measure of the cost of borrowing cash overnight, collateralized by US Treasury-backed securities, and thus arises from a directly observable, liquid market. To the extent alternative reference rates other than SOFR may also be used in the market to replace USD LIBOR, SEC staff will monitor whether the adoption of a variety of alternative rates instead of one dominant alternative could limit the effectiveness of all replacement benchmarks.

[5] The International Swaps and Derivatives Association (ISDA) is also developing fallback language particularly for derivatives contracts.

[6] The staff recommends that in considering any effect on liquidity, funds should consider how their 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.

[7] See *FASB Accounting Standards Update 2018-16, Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes* (October 2018), available at https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171492980&acceptedDisclaimer=true.

[8] See *Interest Rate Benchmark Reform, Proposed Amendments to IFRS 9 and IAS 39* (May 2019), available at <https://www.ifrs.org/-/media/project/ibor-reform/ed-ibor-reform-may-19.pdf>.