SEC Statement on LIBOR Replacement: First Analysis

A Lexis Practice Advisor® Practice Note by Bradley Berman, Mayer Brown LLP

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Introduction

This article discusses the public statement dated July 12, 2019, made by the Securities and Exchange Commission's (SEC) Divisions of Corporation Finance, Investment Management and Trading and Markets, and the Office of the Chief Accountant, encouraging market participants to begin the transition away from U.S. dollar LIBOR, which is expected to cease publication in 2021. The SEC's public statement is significant in that it adds the voice of a non-bank regulator to the discussion on replacing LIBOR. As noted by the SEC, the upcoming LIBOR discontinuance "may present a material risk for certain market participants, including public companies, investment advisers, investment companies and broker-dealers."

Initial Guidance

Prior to the SEC's public statement, the Alternative Reference Rates Committee (ARRC), a group convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York, has been the main source of guidance to market participants in the areas of loans, derivatives and floating rate notes based on U.S. dollar LIBOR. To a casual observer, it might have appeared that the concerns were being voiced mainly by banking regulators and that the potential risks relating to the cessation of U.S. dollar LIBOR were confined to the financial services industry. The Division of Corporation Finance stated that the "companies most frequently providing LIBOR transition disclosure are in the real estate, banking, and insurance industries," but also encouraged every company, if it has not done so 4already, to begin planning for the transition away from LIBOR.

The Division of Corporation Finance focused on disclosure of risks and events that a reasonable investor would consider important to an investment decision. Disclosure relating to the expected LIBOR discontinuance could be triggered by risk factor disclosure requirements (Item 105 of Regulation S-K and Item 3.D of Form 20-F), management's discussion and analysis (Item 303 of Regulation S-K and Item 5 of Form 20-F), board risk oversight (Item 407(h) of Regulation S-K) and the financial statements. An issuer should keep investors informed about the progress toward risk identification and mitigation, and the anticipated effects on the issuer, if material.

The Division of Trading and Markets addressed the effect that a LIBOR discontinuation would have on broker-dealers, central counterparties and exchanges, noting that these parties may:

- Issue instruments or be party to transactions, including derivative transactions, referencing LIBOR
- Own investments that reference LIBOR or make a market in instruments that reference LIBOR
- Have LIBOR-based hedges in place
- Underwrite, place or advise on the issuance of instruments referencing LIBOR
- Recommend investments in LIBOR-based securities, including to retail investors –and–
- Have listing and clearing standards that do not contemplate a LIBOR replacement benchmark

The Office of the Chief Accountant highlighted the effect that a transition away from LIBOR could have on the accounting and financial reporting for:

- Modifications of terms within debt instruments
- Hedging activities
- Inputs in valuation models –and–
- Potential income tax consequences

Replacement Rate Neutrality

The SEC, after noting that the secured overnight financing rate (SOFR) has been proposed as a replacement for U.S. dollar LIBOR, mentioned that some market participants are also considering other U.S. dollar reference rates for certain instruments and that it does not endorse the use of any particular reference rate. This is an interesting contrast to previous statements by the ARRC, which strongly supports the use of SOFR to replace LIBOR. The SEC also said that the Staff "is monitoring whether the adoption of a variety of replacements rates for USD LIBOR instead of the emergence of a dominant successor could limit the effectiveness of all replacement benchmarks."

SEC Chair Jay Clayton's Speech in November 2019

In a speech on November 4, 2019, SEC Chair Jay Clayton lauded current efforts to replace LIBOR and referred to SOFR as a "potential replacement." He also voiced his concern that "more work needs to be done for the transition to avoid substantial frictions, including frictions that will harm investors directly, through higher costs, and as a result of uncertainty more generally." Chair Clayton gave a simplified explanation of his concerns, noting that current LIBOR securities reflect three components: a risk free rate, a bank funding/base lending spread over the risk free rate and an additional fixed spread to/from the lender/borrower or customer. The last would be the typical spread added to a LIBOR floating rate note. Current 3-month USD LIBOR incorporates the risk free rate and the spread over the risk free rate.

In contrast, SOFR is just a risk free rate, but does not reflect the fluctuating bank funding spread over the risk free rate. A SOFR product, such as a SOFR floating rate note, would incorporate the SOFR rate and a fixed spread, but would not fully incorporate the floating bank funding spread. In Chair Clayton's view, this would "make a like-for-like mapping of a LIBOR product to a SOFR product challenging."

Looking Ahead

As the SEC's statement and Chair Clayton's speech show, there is some daylight between regulators with respect to enthusiasm about SOFR as a LIBOR replacement. The ARRC and the SEC are in agreement that there should be no delay in replacing LIBOR in floating rate notes and other LIBOR-based financial instruments. However, the SEC's focus is on disclosure, effects on financial parties and accounting and financial reporting, with a pronounced neutral stance on the efficacy of SOFR as a replacement rate. The ARRC is all in with SOFR as the replacement rate for LIBOR.

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Bradley Berman is counsel in Mayer Brown's New York office and a member of the Corporate & Securities practice. He represents domestic and non-US issuers on domestic and international securities offerings of structured products linked to equities, commodities, interest rates, currencies and other underlying assets. Bradley has extensive experience with exchange-traded notes. He advised Royal Bank of Canada and RBC Capital Markets LLC on the first exchange-traded note issued by a Canadian issuer into the United States and has since advised Royal Bank of Canada and another Canadian issuer on multiple exchange-traded notes. He also represented a non-US frequent issuer on all of their exchange-traded notes for three years. Bradley also has expertise in advising issuers and dealers on the creation of proprietary indices. Bradley advises issuers on shelf registration statements and medium term note programs and issuances exempt from registration under Regulation S, Rule 144A or Section 3(a)(2). He has worked on many bank note issuances by state and national banks. Bradley also advises broker-dealers on the FINRA communication rules and suitability issues. His work previously involved capital-raising debt and equity transactions for large bank holding companies, including several common stock issuances. He has extensive experience with negotiating underwriting, distribution and dealer agreements and related deal documents, including indentures.

Recently, Bradley advised an issuer on establishing a registered structured warrant program, including post-effectively amending their registration statement to add a new class of warrants and drafting the issuer's first warrant indenture.

Bradley is co-author of Considerations for Foreign Banks Financing in the United States (2012; updated 2014, 2016), published by International Financial Law Review.