MAYER | BROWN

June 23, 2020

Legal Update

SEC's OCIE to Begin LIBOR Preparedness Exams

On June 18, 2020, the Office of Compliance, Inspections and Examinations ("OCIE") of the US Securities and Exchange Commission ("SEC") announced in a risk alert (the "Risk Alert") that it will conduct examinations of SEC-registered investment advisers, broker-dealers and investment companies ("registrants"), among others, to assess their preparedness for LIBOR's expected discontinuation. In a clear warning to registrants regarding LIBOR preparedness, OCIE stated the following in the Risk Alert:

> Preparation for the transition away from LIBOR is *essential* for minimizing *any* potential adverse effects associated with LIBOR discontinuation. 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 (emphasis added).

OCIE commented in the Risk Alert that LIBOR is used extensively in the United States and globally as a "benchmark" or "reference rate" for various commercial and financial contracts (such as bonds and loans, floating rate mortgages, asset-backed securities, and interest rate swaps and other derivatives). OCIE expressed its view that LIBOR's discontinuation, currently expected to occur after 2021, could have a *significant* impact on the financial markets and may present a *material* risk for registrants (*emphasis added*).

The Risk Alert publication follows through on the OCIE's earlier announcement that LIBOR preparedness would be an examination priority for 2020.

LIBOR Generally

LIBOR is the interest rate at which banks offer to lend funds to one another in the international interbank market. It was designed to reflect how much it costs banks to borrow from each other in specified currencies for specified periods of time (tenors). LIBOR is the benchmark reference for determining interest rates for a variety of debt and derivative instruments and other commercial transactions, such as mortgages, corporate loans, government bonds, structured finance products.

LIBOR is a fixed rate that is quoted for a specified tenor (typically one, three, or six months) and for a specific currency. At the end of that time period, the rate can be re-set based on then-current rate quotations. According to Bloomberg, LIBOR underpins over $350 trillion of mortgages, loans and derivatives globally. The combined exposure for various asset classes that are priced based on USD LIBOR exceeds $200 trillion. Derivatives account for approximately 90 percent of this exposure.

In the United States, the Alternative Reference Rates Committee ("ARRC") was convened by the Federal Reserve Board and New York Federal Reserve Bank in 2017[1] and charged with determining a preferred alternative to LIBOR for US Dollars. In 2017, ARRC selected the Secured Overnight Financing Rate ("SOFR") as the preferred rate to replace LIBOR.[2] SOFR is a combination of three overnight Treasury repurchase rates. Some key differences between LIBOR and SOFR include:

- SOFR is a backward-looking historic rate, not a forward rate like LIBOR.
- SOFR is an overnight rate, not a term rate like LIBOR.
- SOFR is a secured, risk-free rate, not an unsecured cost of funds rate like LIBOR.
- The SOFR market is liquid, deep, and transparent, unlike current LIBOR.
- SOFR does not track like LIBOR. For example, SOFR is more volatile at quarter- and year-ends and tends to move down in a distressed market while LIBOR moves up.

The ARRC has said that it will attempt to develop a SOFR term rate, but meanwhile favors SOFR compounded in arrears (Compound SOFR). In March 2020 the NY Fed began to publish 30-, 90-, and 180-day Compound SOFR. Other global regulators have indicated that they favor compounded overnight rates to term rates.

Prior SEC and Staff Statements Regarding the LIBOR Transition

The SEC and its staff have issued a number of statements regarding the LIBOR transition. For example, in a December 2018 speech, SEC Chairman Jay Clayton discussed the market risks associated with the LIBOR transition.[3] In July 2019, the SEC's Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant published a joint statement regarding the LIBOR transition and registrant preparedness (the "Joint Statement").[4]

> The Joint Statement provides general commentary regarding LIBOR preparedness, but also includes division-specific guidance and commentary, which registrants may find particularly helpful in preparing for upcoming OCIE examinations and interpreting the Risk Alert.

Further, as mentioned above, in January 2020, OCIE identified registrant preparedness for the LIBOR transition as an examination program priority for 2020:[5]

> . . . OCIE will be reviewing firms' preparations and disclosures regarding their readiness particularly in relation to the transition's effects on investors. Some registrants have already begun this effort and OCIE encourages each registrant to evaluate its organization's and clients' exposure to LIBOR, not just in the context of fallback language in contracts, but its use in benchmarks and indices; accounting systems; risk models; and client reporting, among other areas. Insufficient preparation could cause harm to retail investors and significant legal and compliance, economic and operational risks for registrants.

OCIE's Examination Focus

OCIE stated in the Risk Alert that in its examinations, OCIE will review, among other things, whether and how the registrant has evaluated the potential impact of the LIBOR transition on the registrant's:

- Business activities;
- Operations;
- Services; and
- Customers, clients, and/or investors (collectively, "investors").

OCIE also will review the plans that registrants have developed and steps they have taken to prepare for the LIBOR discontinuation, including:

- The registrant's and investors' exposure to LIBOR-linked contracts that extend past the current expected discontinuation date, including any fallback language incorporated into these contracts;
- The registrant's operational readiness, including any enhancements or modifications to systems, controls, processes, and risk or valuation models associated with the transition to a new reference rate or benchmark;
- The registrant's disclosures, representations, and/or reporting to investors regarding its efforts to address LIBOR discontinuation and the adoption of alternative reference rates;
- The registrant's identification and handling of any potential conflicts of interest associated with the LIBOR discontinuation and the adoption of alternative reference rates; and
- Clients' efforts to replace LIBOR with an appropriate alternative reference rate.

The Sample Document Request List

Interestingly, OCIE included as an appendix to the Risk Alert a sample document request list, detailing the types of information and documents that may be used or requested in these examinations. That appendix, which includes no less than 20 items, has been set out in Exhibit A hereto.

> The sample document request list is extensive and serves as a road map to OCIE's current LIBOR preparedness expectations for registrants. Registrants would be wise to review the list carefully and respond accordingly—and quickly.

Resources Regarding the LIBOR Transition

In the Risk Alert, OCIE encouraged registrants to use the ARRC's website[6] to receive updates about the latest transition-related developments and best practices. In addition, OCIE expressed an interest in engaging in a discussion of the transition and encouraged the public to share information about the potential impact of the expected discontinuation of LIBOR via e-mail to LIBOR@sec.gov.

Extensive additional resources can be found on Mayer Brown's IBOR Transition webpage, which provides a comprehensive repository of global regulatory guidance and updates, and presents Mayer Brown's thought leadership on IBOR-transition topics, such as a recent presentation on the role of artificial intelligence in LIBOR transition planning.[7]

Conclusion

The Risk Alert represents the latest effort by the SEC and its staff to sound the alarm regarding LIBOR transition preparedness, whether through the Joint Statement, OCIE's examination priorities, or speeches or other announcements. All of these resources—and particularly the attached document request list—are important tools for registrants to use in their LIBOR preparedness. That said, it would be prudent for registrants to look beyond those resources and conduct a careful, tailored evaluation of LIBOR transition impacts, which may necessitate modifications to, among other things, investment, cash management and trading strategies, restrictions and guidelines.

For those of you who were industry participants in 1999, the regulatory messaging from the SEC and its staff regarding the LIBOR transition preparedness might sound familiar. But after all of the focus on and preparedness for the year 2000, that transition did not result in significant disruption to or adverse impact on our industry. However, without proper preparation, the same might not be said regarding the pending LIBOR transition.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Leslie S. Cruz
+1 202 263 3337
lcruz@mayerbrown.com

J. Paul Forrester
+1 312 701 7366
jforrester@mayerbrown.com

Anna T. Pinedo
+1 212 506 2275
apinedo@mayerbrown.com

Endnotes

[1] The ARRC is comprised of various private-market participants, including banks, asset managers, insurers and industry trade organizations, and official sector ex-officio members, including the SEC.

[2] Other global working groups have recommended alternative reference rates for their currencies.

[3] Speech by SEC Chairman Jay Clayton, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks (December 6, 2018) at https://www.sec.gov/news/speech/speech-clayton-120618.

[4] Staff Statement on LIBOR Transition (July 12, 2019) at https://www.sec.gov/news/public-statement/libor-transition; Mayer Brown REVERSEinquiries article "LIBOR: Just Say No" (June 27, 2019) at https://www.mayerbrown.com/en/perspectives-events/publications/2019/06/reverseinquiries-volume-2-issue-6.

[5] Mayer Brown Legal Update "More US Regulators Make LIBOR Transition Preparedness an Examination Priority" (January 17, 2020) at https://www.mayerbrown.com/en/perspectives-events/publications/2020/01/more-us-regulators-make-libor-transition-preparedness-an-examination-priority.

[6] https://www.newyorkfed.org/arrc

[7] To help ensure that clients are fully prepared for the transition, Mayer Brown also has teamed up with Morae Global Corporation, a compliance solutions provider experienced in data analytics and remediation, technology enablement, repapering and program management.

Exhibit A

This document provides a sample list of requests for information that OCIE may use in conducting examinations of registered entities regarding their LIBOR discontinuation preparations. OCIE has published this document as a resource for registered entities. This document should not be considered all-inclusive of the information that OCIE may review or specifically indicative of the validation and testing we may perform of a registrant's policies and procedures. Accordingly, OCIE will alter its requests for information, as well as potentially vary whether it asks for production of information in advance of an examination or review certain information onsite, as it considers the specific circumstances presented by each registrant.

> OCIE noted that some of the information set out below was discussed in the Joint Statement.

1. Information regarding registrant's organizational structure and business lines, particularly regarding the individuals, positions, departments, and operations that may be impacted by discontinuation of LIBOR transition and transition to an alternative rate (collectively, the "LIBOR Transition").
2. Information regarding any individuals or groups (e.g., internal committees, working groups, or transition teams) assigned responsibility to oversee or manage the effects of the LIBOR Transition on the registrant, including information regarding the frequency of any meetings on this topic and whether minutes are kept.
3. The identity of any third parties registrant has utilized or plans to utilize to assess the impact of the LIBOR Transition on the firm or its clients, customers, or investors (collectively, "investors").
4. Documentation or descriptions of any analysis performed to identify contracts or obligations held and/or issued by registrant or its investors that may be affected by the LIBOR Transition and any remediation plans thereof.
5. Documentation or descriptions of any performance composites or performance advertising that use a benchmark that could potentially be affected by the LIBOR Transition and any remediation plans thereof.
6. Information regarding any investors whose fee structure (e.g., performance-based fees) or performance reporting (e.g., use of LIBOR-linked benchmark) could potentially be affected by the LIBOR Transition.
7. Any written assessments, strategic plans (including remediation plans, as applicable), road maps, or timelines prepared by or for registrant regarding preparation for the LIBOR Transition, including the consideration of alternative reference rates.
8. Documentation of any risk management matrices or risk inventories of registrant that reference the LIBOR Transition, including a description of any LIBOR Transition-related vulnerabilities or exposure covered by the matrix or inventory.
9. Documentation or descriptions of any analysis performed to identify LIBOR-based risk or valuation models used by registrant, including information regarding changes that may be needed to account for a new reference rate, if any.
10. Materials referencing the LIBOR Transition provided to registrant's board of directors, any committee of the board of directors, any board member, the board or board member(s) of any

investors, or the board, legislative body or member(s) thereof of any municipal entity or obligated person client, if applicable, or equivalent governing bodies or offices, if registrant is not organized as a corporation.

11. Information regarding any third-party vendors registrant uses that may be impacted by the LIBOR Transition, including the services provided (e.g., back office) and how the vendor maybe impacted.
12. Information regarding any LIBOR-linked contracts or obligations that extend past the current expected discontinuation date that are held and/or issued by registrant, including the implications and impact of any incorporated fallback language.
13. Information regarding any LIBOR-linked contracts or obligations that extend past the current expected discontinuation date that are held and/or issued by registrant's investors, including the implications and impact of any incorporated fallback language.
14. Information regarding any contracts or obligations held and/or issued by registrant, or its investors, that reference a rate identified as an alternative to LIBOR (e.g., SOFR).
15. Information regarding any changes made or planned to be made to registrant's information technology systems (e.g., accounting, investor reporting, risk, valuation or trading) to accommodate the LIBOR Transition, including any changes to accommodate new instruments/contracts and rates with features that differ from LIBOR.
16. Disclosures provided in registrant's filings with the SEC and/or to investors (e.g., in prospectuses) about the LIBOR Transition, including fallback language for LIBOR instruments, as applicable, during the period of January 2019 to the present.
17. Any guidance provided by registrant to employees or supervised persons concerning recommendations to investors to purchase, sell, or enter into LIBOR-linked instruments or contracts that extend past the current expected discontinuation date, reviews of portfolios containing such instruments, or the underwriting of new instruments referencing LIBOR, if applicable.
18. Any guidance provided by registrant to employees or supervised persons regarding the provision of advice to issuers of new LIBOR-linked instruments.
19. Any guidance provided by registrant to employees or supervised persons regarding the provision of advice to clients regarding the replacement of LIBOR in outstanding contracts or obligations with an appropriate alternative reference rate.
20. Any implemented or planned changes to compliance procedures, controls, or surveillance systems designed to monitor for LIBOR-linked instruments or contracts recommended or sold to clients.