

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware



www.meritas.org

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OCIE Examining LIBOR Transition Preparedness

On June 18, the Office of Compliance Inspections and Examinations (OCIE) of the Securities Exchange Commission (SEC) released a Risk Alert (the Risk Alert)¹ discussing their examination initiative in relation to the transition from the London Interbank Offered Rate (LIBOR). With the discontinuation of LIBOR slated for the end of 2021 (LIBOR Transition), OCIE has previously included LIBOR Transition preparedness on their list of Examination Priorities for the fiscal year 2020.² The Risk Alert clarifies that COVID-19 is not delaying OCIE examinations. It provides specific considerations and documents that OCIE will use in its reviews of investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies (collectively, the Registrants).

Background

The SEC and OCIE have pushed Registrants to prepare for the transition away from LIBOR.³ The SEC has previously noted that a failure to transition in a timely manner will exacerbate the risks and economic impact of the LIBOR Transition.⁴ While the SEC and the Division of Investment Management have discussed the LIBOR Transition, they have not advocated for any set transition plans, required replacement rate, contractual terms, or other specifics beyond requiring Registrants to consider if the “consequences of the discontinuation of LIBOR are risks that they should disclose to investors.”⁵ For the first time, OCIE’s Risk Alert has enumerated some of the specific considerations and documents that will be used to review Registrants.

Examination Focus

OCIE plans to conduct examinations of a variety of Registrants over the coming year to assess their transition preparedness. OCIE notes that it intends to engage with Registrants through this review process, and as these engagements commence, best practices and more specifics will come to light. OCIE will focus on whether and how the Registrant has evaluated the potential impact of the LIBOR Transition on its: (i) business activities, (ii) operations, (iii) services, and (iv) customers, clients, and/or investors (collectively, investors). For example, OCIE plans to review:

- The Registrant’s and its 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;

- Identifying and addressing any potential conflicts of interest associated with the LIBOR Transition and the adoption of alternative reference rates; and
- Investors' efforts to replace LIBOR with an appropriate alternative reference rate.

Of note, OCIE did not specify a preferred new reference rate or benchmark, nor did it set a timeframe for when a transition should be finalized. However, OCIE notes that Registrants should utilize the information provided by the Alternative Reference Rates Committee (ARRC) to stay up to date on current events.⁶ It should be expected that as OCIE's review progresses, and the discontinuation date of LIBOR nears, OCIE likely will provide more details and best practices.

Potential Requests for Information

The Risk Alert includes a sample list of requests that provides Registrants a good starting point toward being prepared for a potential review. In general, as Registrants conduct their internal transition process, documentation should be retained to highlight the methods, processes, outcomes and conclusions of such actions.

Some of OCIE's specific requests include, among others:⁷

1. The identity of any third parties that the Registrant has utilized or plans to utilize to assess the impact of the LIBOR Transition on the firm or investors;
2. Documentation or descriptions of any analysis performed to identify contracts or obligations held by the Registrant that may be affected by the LIBOR Transition and any remediation plans thereof;
3. 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;
4. Any written assessments, strategic plans (including remediation plans, as applicable), roadmaps, or timelines prepared by or for the Registrant regarding preparation for the LIBOR Transition, including the consideration of alternative reference rates;
5. Documentation or descriptions of any analysis performed to identify LIBOR-based risk or valuation models used by the Registrant, including information regarding changes that may be needed to account for a new reference rate, if any;
6. Materials referencing the LIBOR Transition provided to the Registrant's board of directors, any committee of

For more information, contact:



Sara P. Crovitz
202.507.6414
scrovitz@stradley.com



John "JJ" Dikmak Jr.
215.564.8025
jdikmak@stradley.com

the board of directors, any board member, the board or board member(s) of any investors of the Registrant, 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 the Registrant is not organized as a corporation;

7. Information regarding any LIBOR-linked contracts or obligations that extend past the current expected discontinuation date that are held and/or issued by the Registrant, including the implications and impact of any incorporated fallback language;
8. Information regarding any contracts or obligations held and/or issued by the Registrant, or its investors, that reference a rate identified as an alternative to LIBOR (e.g., SOFR);
9. Disclosures provided in Registrant's filings with the Commission 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; and
10. 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.

Conclusion

While the end result of the LIBOR Transition remains unclear, Registrants should consider and be ready to respond to OCIE's sample requests to demonstrate their good faith efforts to be prepared. The OCIE Risk Alert generally focuses on Registrants' disclosure, operational capacity and conflicts of interest. Further guidance and best practices likely will be forthcoming.

¹ Office of Compliance Inspections and Examination, Examination Initiative: LIBOR Transition Preparedness, (June 18, 2020), available at <https://www.sec.gov/ocie/announcement/risk-alert-libor-initiative>.

² See OCIE, Examination Priorities for 2020, available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf>.

³ See Stradley Ronon Stevens and Young, LIBOR Transition Game Plan: A Guide for Asset Management Firms, (Sept. 30, 2019), available at <https://www.stradley.com/insights/publications/2019/09/fund-alert-september-2019>.

⁴ SEC Staff Statements from the Divisions of Corporation Finance, Investment Management and Trading and Markets, and the Office of the Chief Accountant, Staff Statement on LIBOR Transition (July 12, 2019), available at <https://www.sec.gov/news/public-statement/libor-transition>.

⁵ Id.

⁶ Although neither the SEC nor OCIE have specified a preferred new reference rate, the ARRC does recommend the Secured Overnight Financing Rate (SOFR) as an alternative.

⁷ For the full list, see Appendix A of the Risk Alert available at <https://www.sec.gov/ocie/announcement/risk-alert-libor-initiative>.