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# SEC Staff Issues Statement on LIBOR Transition

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The SEC staff recently issued a [statement](#)<sup>1</sup> (the “Statement”) that:

- Discusses the expected discontinuation of LIBOR<sup>2</sup> use and how the transition from LIBOR may significantly affect financial markets and market participants (including public companies, investment companies and advisers, and broker-dealers).
- Lists questions and considerations for market participants related to new or existing contracts and other business risks.
- Provides specific guidance from the SEC’s divisions of Corporation Finance, Investment Management, and Trading and Markets and its Office of the Chief Accountant.

Although the Statement focuses on LIBOR, its guidance is also relevant to market participants that may be affected by a transition from other reference rates.

## Background

The use of LIBOR is pervasive in today’s markets as a benchmark or reference rate in contracts such as derivatives (e.g., interest rate swaps), corporate and consumer loans and mortgages, and corporate and municipal bonds. LIBOR is calculated daily by the Intercontinental Exchange for five currencies, including the euro, the British pound, the Japanese yen, the Swiss franc, and the U.S. dollar, and for seven maturities or tenors including overnight/spot next, one week, one month, two months, three months, six months, and twelve months, resulting in the daily reporting of 35 LIBOR rates that are used in various financial products and instruments worldwide. The Statement notes that “[i]t is expected that a number of

<sup>1</sup> *Staff Statement on LIBOR Transition.*

<sup>2</sup> The London Interbank Offered Rate — officially, ICE LIBOR (i.e., Intercontinental Exchange LIBOR).

private-sector banks currently reporting information used to set LIBOR will stop doing so after 2021 when their current reporting commitment ends, which could either cause LIBOR to stop publication immediately or cause LIBOR’s regulator to determine that its quality has degraded to the degree that it is no longer representative of its underlying market.”

To prepare for the possible discontinuation of LIBOR, certain jurisdictions in which the use of LIBOR is prevalent have formed working groups to develop possible successor alternative reference rates (ARRs). In the United States, the Alternative Reference Rates Committee (ARRC) has designated the Secured Overnight Financing Rate (SOFR) as the recommended alternative rate for U.S. dollar-based LIBOR. The Statement notes that “SOFR is a measure of the cost of borrowing cash overnight, collateralized by U.S. Treasury securities, and is based on directly observable U.S. Treasury-backed repurchase transactions.” Some market participants, however, may continue to explore whether other U.S. dollar reference rates would be more appropriate for certain instruments. (For example, a reference rate that offers tenors longer than an overnight rate may be appropriate for certain longer-term contracts.) The Statement notes that the SEC does not plan to endorse any single reference rate; however, the SEC staff will monitor transition efforts and assess “whether the adoption of a variety of replacement rates for USD LIBOR instead of the emergence of a dominant successor could limit the effectiveness of all replacement benchmarks.”

Although there are still some questions about the ultimate resolution and timing of the transition from LIBOR, the SEC staff strongly encourages market participants that have not already done so to begin assessing their risks associated with the transition. Furthermore, the staff notes that it is actively monitoring participants’ progress with their risk identification and risk management efforts related to the LIBOR transition.

## General Guidance

### Existing Contracts

The SEC staff encourages market participants to assess their exposure to LIBOR in existing contracts that extend beyond 2021 in a timely manner to avoid potential market or business disruptions. The Statement notes that many such contracts “did not contemplate the permanent discontinuation of LIBOR and, as a result, there may be uncertainty or disagreement over how the contracts should be interpreted. In addition, in circumstances where the contractual interpretation is clear, the adjustment may be inconsistent with expectations of the affected parties” (e.g., a floating-rate contract would become fixed-rate). Since renegotiating contracts with counterparties can be time-consuming, it is important for market participants to be timely in their assessment of LIBOR exposure. The Statement provides a list of questions to help market participants identify and manage risks associated with the LIBOR transition. The questions outline actions that market participants should consider taking, including the following:

| Type of Assessment               | Actions That Market Participants Should Consider   |
|----------------------------------|--|
| Identification of LIBOR exposure | <ul style="list-style-type: none"><li>Identify contracts that extend beyond 2021 that contain references to LIBOR.</li><li>Assess the materiality of such contracts individually and in the aggregate for risk management and disclosure purposes.</li><li>Determine the effects of LIBOR discontinuation on contract operation.</li></ul> |

(Table continued)

| Type of Assessment   | Actions That Market Participants Should Consider  |
|--|---|
| Analysis of contractual fallback provisions <sup>3</sup>   | <ul style="list-style-type: none"><li>• Determine whether contracts have fallback provisions that are triggered by the unavailability of LIBOR.</li><li>• Assess whether there is a need to mitigate risks (e.g., determine whether there is a need to renegotiate with the contract counterparty).</li></ul>   |
| Analysis of alternative reference rate (ARR) ramifications | <ul style="list-style-type: none"><li>• Identify the ARR that would replace LIBOR in the affected contracts (e.g., SOFR).</li><li>• Assess whether there are fundamental differences between LIBOR and the ARR that could affect contract profitability or costs (e.g., different counterparty credit risk).</li><li>• Assess whether there is a need to adjust the ARR (e.g., by adding or adjusting the credit spread) to maintain the same economics for affected contracts.</li><li>• Determine whether the ARR introduces new risks that must be addressed (e.g., assess whether LIBOR-based contracts that were entered into to provide an economic hedge will still be effective under the ARR).</li></ul> |
| Analysis of hedging implications                           | <ul style="list-style-type: none"><li>• Assess the effect of LIBOR discontinuation on the effectiveness of hedging strategies in which a LIBOR-based contract was used to hedge floating-rate investments or obligations.</li></ul>   |

## New Contracts

The SEC staff encourages market participants that enter into new contracts to assess whether those contracts should refer to an ARR instead of LIBOR or should incorporate fallback provisions that take into account the LIBOR transition. The Statement notes that the “ARRC has published recommended fallback language for new issuances of floating rate notes, syndicated loans, bilateral business loans, and securitizations” (footnotes omitted). The Statement also acknowledges the efforts of the International Swaps and Derivatives Association to develop “robust fallback language” for derivative contracts.

## Other Business Risks

The Statement notes that the discontinuation of LIBOR may affect other aspects of a market participant’s business, including “strategy, products, processes, and information systems.” Accordingly, market participants should assess their own facts and circumstances to determine whether they will need to undertake mitigation efforts to address these broader business risks. The Statement indicates that “prudent risk management may necessitate the establishment of a task force to assess the impact of financial, operational, legal, regulatory, technology, and other risks.”

## Division-Specific Guidance

In addition to listing general questions about the anticipated LIBOR transition that apply to all market participants, the Statement contains division-specific guidance that may be of particular interest to certain SEC registrants. The SEC staff encourages market participants to review all of the division-specific guidance, however, because “[r]egistrants may find guidance provided by a division or office, other than the one they view as their primary [SEC] staff contact, insightful with respect to certain of their circumstances.”

<sup>3</sup> In this context, a fallback provision in a contract that refers to LIBOR would indicate how the terms of that contract would operate should a specified triggering event occur that would indicate that the quoted LIBOR rate was no longer available or deemed unreliable. For example, a triggering event could be the cessation of a reported LIBOR rate or a determination by a regulator that LIBOR was no longer representative of the underlying market. A fallback provision might specify a replacement rate that would be used should the triggering event occur, or it might state that interest rate in the contract would stay fixed at the last reported LIBOR rate.

## Division of Corporation Finance

The staff in the SEC's Division of Corporation Finance notes in the Statement that the anticipated LIBOR discontinuation could trigger a need for market participants to provide disclosures under different SEC rules and regulations, including those addressing "risk factors, management's discussion and analysis, board risk oversight and financial statements" (footnotes omitted). All entities should assess their potential exposures, since those that are counterparties to LIBOR-linked contracts could be affected by the LIBOR transition.

Because of the potentially significant impact that LIBOR transition could have on an entity's business, market participants are encouraged to provide disclosures that "allow investors to see this issue through the eyes of management." Market participants should consider disclosing:

- The status of their risk identification and mitigation efforts to date, including a discussion of any significant matters that remain to be addressed.
- Appropriate qualitative information (or quantitative information, if material) about their exposures (e.g., quantifying the notional value of LIBOR-linked contracts that are in effect beyond 2021).
- The existence of any anticipated material exposures arising from the LIBOR transition that cannot yet be reasonably estimated.



### Connecting the Dots

The SEC staff has observed that registrants in the banking, real estate, and insurance industries have been the most likely to disclose information about risks associated with the transition from LIBOR. The staff urges all registrants, including those outside the financial services industries, to assess the need to disclose LIBOR transition risks, uncertainties, and known trends.

The Statement does not establish any new disclosure obligations but rather presents the staff's views on how the SEC's existing rules should be interpreted in connection with the transition from LIBOR. When evaluating the potential impact of future benchmark rate changes, registrants are encouraged to consider the effect that the changes could have on cost of credit and the value of assets as well as the financial impact of contractual fallback provisions. Further, if there are material changes to systems or controls, registrants may need to consider disclosing such information. Given the evolving nature of this transition, registrants should also update their disclosures as material new information becomes available.

## Other Divisions

The table below summarizes certain considerations raised by the SEC's Division of Investment Management and Division of Trading and Markets. The staff of both divisions is actively monitoring how LIBOR discontinuation may affect (1) investment companies (i.e., funds) and advisers and (2) broker-dealers, central counterparties, and exchanges, respectively.

| Division              | Actions That Market Participants Should Consider  |
|-----------------------|---|
| Investment Management | <ul style="list-style-type: none"> <li>• Determine whether LIBOR discontinuation will affect the functioning, liquidity, or value of investments that refer to LIBOR, such as floating-rate loans and debt, derivatives, and certain asset-backed securities.</li> <li>• Assess whether the fallback language in contracts (or lack thereof) could affect investment liquidity or valuation.</li> <li>• If a liquidity impact is anticipated because of the LIBOR transition, assess whether that impact will affect investment classification or alter the effectiveness of a fund's liquidity risk management programs.<sup>4</sup></li> <li>• Assess the possible impact of LIBOR transition on funds that do not invest in LIBOR-linked instruments (e.g., determine whether closed-end funds or business development companies that lend directly will need to renegotiate contracts that extend beyond 2021).</li> <li>• Assess the need for disclosure and consider providing tailored disclosures that detail the anticipated impact of the LIBOR transition on fund holdings.</li> <li>• Advisers should consider the effects that the pending LIBOR transition may have on LIBOR-linked instruments that they may recommend to or monitor for clients.</li> </ul> |
| Trading and Markets   | <ul style="list-style-type: none"> <li>• Assess potential exposures to LIBOR transition, including whether the entity (1) issues instruments or becomes a party to transactions that refer to LIBOR; (2) owns or makes a market in LIBOR-linked instruments; (3) designates LIBOR-based hedges; (4) underwrites, places, or advises on the issuance of LIBOR-linked instruments; (5) "recommend[s] securities that reference LIBOR, including in relation to retail investors"; or (6) "[has] listing and clearing standards that do not contemplate new benchmarks."</li> <li>• Analyze whether the LIBOR transition will affect a participant's "business, systems, models, processes, risk management frameworks, and clients" and take appropriate action if warranted.</li> <li>• Consider whether to inform clients and markets about any risks identified that are related to the transition.</li> </ul>   |

## Office of the Chief Accountant

The staff in the SEC's Office of the Chief Accountant (OCA) emphasized that the LIBOR transition could significantly affect a market participant's financial reporting and its accounting in different areas, including (1) debt modifications, (2) hedge accounting, (3) valuation (i.e., inputs used in valuation models), and (4) income taxes. Accordingly, the OCA staff will actively monitor the efforts of preparers, other regulators, and standard setters (e.g., the FASB) to address potential issues. The OCA staff also reminded market participants that it is available for any prefiling consultations.

In a [speech](#) at the 2018 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff addressed certain cash flow hedging issues that could arise from the LIBOR transition. The OCA staff indicated that it would not object to a view that in cash flow hedging relationships, an entity (1) could continue to assert that it is probable that hedged LIBOR-based interest payments will occur beyond the anticipated LIBOR transition date and (2) would not need to factor the impending LIBOR transition into its hedge effectiveness assessment. For additional discussion of the staff's speech, see Deloitte's December 16, 2018, [Heads Up](#).

<sup>4</sup> This assessment should be performed "to ensure compliance with Rule 22e-4 under the Investment Company Act of 1940."

The OCA staff also acknowledged the FASB's efforts to proactively address accounting issues that could result from the LIBOR transition. In October 2018, the FASB issued ASU 2018-16,<sup>5</sup> which added the overnight index swap rate based on SOFR to the list of accepted benchmark interest rates in the United States for hedge accounting purposes. As a result of this benchmark interest rate designation, entities may find the SOFR more appealing as an ARR in financial contracts. The FASB has also added a separate project to its agenda to address known accounting issues that market participants may encounter because of the LIBOR transition.



### Connecting the Dots

To date, the FASB has held two meetings to discuss issues related to the LIBOR transition. At its June 19, 2019, meeting, the Board discussed scope criteria for the project and tentatively decided to provide entities with relief from applying the guidance on debt modifications and troubled debt restructurings, lease modifications, and the reassessment of embedded derivatives. The Board tentatively decided that for other contract modifications, it would establish a principle that contract modifications necessitated by LIBOR transition (or transition from other rates expected to be discontinued) would be considered continuations of the original contract. Entities would be able to avail themselves of the relief on a topic-by-topic basis.

At its July 17, 2019, meeting, the Board discussed hedging accounting relief, the transition method for the relief's application, required disclosures, and the relief period. Under the Board's tentative decisions, a hedging relationship in which the critical terms of the hedging instrument or hedged item change because of reference rate reform could continue and not require dedesignation. Similarly, entities could change the designated benchmark interest rate in a fair value hedge without having to dedesignate the hedge if that benchmark interest rate was affected by reference rate reform. Entities also would be able to apply additional practical expedients related to initial and subsequent hedge effectiveness assessments for affected cash flow hedges. Further, entities would apply the rate reform relief guidance prospectively and provide disclosures about the nature of the relief and their reasons for electing it in interim and annual financial statements of the period of change. The relief guidance would sunset as of January 1, 2023.

In the coming months, the Board expects to issue a proposed ASU related to this guidance for a 30-day comment period. See Deloitte's journal entries on the [June 19](#) and [July 17](#) meetings for additional information.

The OCA staff also noted that the International Accounting Standards Board had recently issued an [exposure draft](#)<sup>6</sup> on certain hedge accounting issues that could arise "in the period before the replacement of an existing interest rate benchmark." See Deloitte's May 2019 *IFRS in Focus* for a discussion of the exposure draft.

### Next Steps

The LIBOR transition could have a pervasive impact on the financial markets and significantly affect market participants' systems, operations, and financial reporting. All entities should gauge their potential exposure to LIBOR, identify potential risks associated with the LIBOR transition, and determine whether action is necessary to mitigate those risks. In particular, entities should assess whether existing contracts that refer to LIBOR and are expected to extend beyond 2021 have effective fallback language so that the entities have sufficient time to take corrective action if necessary. Also, market participants should consider the

<sup>5</sup> FASB Accounting Standards Update No. 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*.

<sup>6</sup> IFRS® Standards Exposure Draft ED/2019/1, *Interest Rate Benchmark Reform — Proposed Amendments to IFRS 9 and IAS 39*.

impending LIBOR transition when they negotiate the terms of new contracts and ensure that such contracts either refer to ARR or incorporate sufficient fallback language if LIBOR is used. SEC registrants also need to be mindful of their disclosure obligations under SEC rules and regulations and ensure that their disclosures are transparent and timely. Further, market participants need to continue to actively monitor the actions of standard setters and regulators to ensure that they comply with financial reporting requirements and avail themselves of any relief that is offered.

Deloitte may be able to help entities with their LIBOR transition efforts. For more details and contact information, see Deloitte's LIBOR transition [Web site](#).

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