



May 11, 2023

Observations from Examinations of Investment Advisers and Investment Companies Concerning LIBOR-Transition Preparedness¹

I. Introduction

U.S. Dollar LIBOR, formerly the London Interbank Offered Rate, is scheduled to be discontinued after June 30, 2023 (“Cessation Date”). In anticipation of this transition, the Division performed a series of examinations to assess registrants’ preparedness for the cessation of LIBOR, and staff of the Divisions of Investment Management and Trading and Markets subsequently issued a statement regarding considerations for market participants.² This alert focuses on exams of registered investment advisers and investment companies (“firms”) and aims to remind firms of the transition as well as summarize some observations from the Division staff (“Staff”) in the recent examinations.

The types of firms reviewed in these examinations included: (i) advisers associated with large bank complexes; (ii) advisers to various types of registered investment companies (*i.e.*, mutual funds, closed-end funds, exchange-traded funds, and business development companies); (iii) small, medium, and large fund complexes; (iv) advisers to private funds that invest in private credit, such as collateralized loan obligations; and (v) large retail-oriented advisers.

II. Observations Concerning Firms’ Practices

Firms’ preparation efforts varied considerably, depending on the type and amount of LIBOR exposure. Most of the examined firms had significant direct exposure to LIBOR-linked contracts. A few, which had large retail client bases, had more limited and indirect exposure. The Staff observed certain practices firms have implemented to address the transition away from LIBOR.

¹ This Risk Alert represents the views of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the “Division”). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the “SEC” or the “Commission”). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all staff statements, has no legal force or effect; it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

² See Division, [Risk Alert - Examination Initiative: LIBOR Transition Preparedness](#) (June 18, 2020); see also OCIE, [2020 Examination Priorities](#); [SEC Staff Statement on LIBOR Transition — Key Considerations for Market Participants](#) (Dec. 7, 2021).

A. Risk Management

- ***Treatment as an enterprise risk governance matter.*** Firms with significant exposures have formed cross-functional LIBOR transition working groups, often overseen by a risk governance committee, created detailed written transition plans with work streams and timelines, and completed comprehensive impact assessments on investment and operational exposures.
- ***Keeping informed and engaged in industry associations.*** Almost all examined firms are either members of the Alternative Reference Rates Committee (“ARRC”) or heavily rely on guidance it has provided. Several firms are also participating in LIBOR transition discussions with relevant industry groups.
- ***Internal training and guidance.*** Firms have made deliberate efforts to ensure that traders, portfolio managers, and client-facing representatives are kept informed and up-to-date concerning both the LIBOR transition generally and any internal policies, procedures or guidance. The nature and extent of training and guidance for such personnel varied considerably based on level of transition impact as well as the firm’s business lines and client types.

B. Operations

- ***Active engagement with service providers, sub-advisers, and third-party managers.*** Firms have planned their level of engagement with service providers, sub-advisers, and third-party managers according to the importance of such entity to the firm’s business or the level of exposure at such entity. Many firms extensively worked with fund administrators and pricing or data providers to understand their transition readiness. Firms commonly used due diligence questionnaires to gauge transition readiness at sub-advisers and third-party managers.
- ***Extensive systems testing.*** Firms that require internal system updates have performed end-to-end testing to confirm systems can accommodate alternative reference rates (“ARRs”) currently used, or will be used post-transition. This is intended to enable such firms to identify issues to remedy or workarounds needed to process ARR’s prior to the Cessation Date.
- ***Reconciliation of settlements and payments.*** Several firms incorporated a rigorous reconciliation processes, aiming to ensure all the terms and conditions of the ARR’s were properly accounted for by counterparties and service providers.

C. Portfolio Management

- ***Early identification of LIBOR exposures.*** Where applicable, many firms took a global approach to contract identification, looking broadly at LIBOR exposure

across subsidiaries and affiliates. Most firms either created or utilized internal tools to track and monitor LIBOR and ARR exposure on a real-time or periodic basis.

- ***Substantive review of fallback provisions.*** Many firms used third-party service providers with specialized skills in document review to identify fallback provisions. Firms proactively assessed risks associated with the various fallback provisions, or lack thereof, and prioritized identifying and assessing contracts considered “tough legacy” that may be more challenging to transition, such as those with fallbacks that give discretion to a third party.
- ***Internal controls and guidance concerning trading of LIBOR-linked contracts.*** Firms considered what, if any, trading restrictions to place on new and legacy LIBOR-linked instruments and communicated their approaches to relevant personnel such as portfolio managers, compliance, *etc.* Some firms created internal controls such as pre-trade compliance checks or purchasing guidance. For example, certain firms created matrices that grouped investments into various “risk buckets” based on fallback language for ease of portfolio manager review in purchasing decisions.
- ***Early transitioning of bank loans and other instruments.*** While many instruments may not be susceptible to early transition, or firms are not in the position to renegotiate them (*e.g.* situations in which the firm is not party to an underlying agreement), firms have been converting to ARRs where practicable and urging counterparties to convert ahead of the Cessation Date.

D. Fiduciary Responsibilities and Investor Communications

- ***Fiduciary duty.*** With regard to firms’ approaches to fulfilling their fiduciary obligations in connection with the transition, the Staff observed advisers with large direct client exposure addressing the remediation of contracts, while advisers with indirect client exposure typically appeared to manage exposure through due diligence on third-party fund managers concerning their transition readiness.
- ***Assessment, disclosure, and mitigation of conflicts of interest and conduct risk.*** As part of their fiduciary duty, firms have considered conflicts of interest related to the transition including, for example, cross-trading, principal transactions, allocation of transition costs, and clients with conflicting priorities. Conduct risks identified have been monitored through firms’ compliance programs.
- ***Risk disclosures.*** Firms with significant exposures included comprehensive disclosures for risks associated with the transition, such as legal, operational, credit, and regulatory risks.
- ***Information sharing with clients.*** The firms implemented a wide range of client communication and engagement strategies, depending on their businesses and their determinations of what information would be meaningful to their clients. Some firms adopted a multifaceted approach, communicating frequently and proactively

with clients that have greater exposures as well as making available more generalized disclosures on their website or in brochures and fund documents.

E. Keeping Informed About Ongoing and New Challenges

As part of their management of the transition, firms have stayed abreast of ongoing and new challenges to a smooth transition, and are working to prepare accordingly. We note a few of them below.

- *Transitioning Bank Loans in Advance of June 30, 2023.* The ARRC has encouraged market participants to remediate as many outstanding LIBOR-linked bank loans as practicable before the Cessation Date, to avoid a flood of contracts requiring individually negotiated amendments in mid-2023.
- *Complex Contracts and Synthetic LIBOR.* A few complexes identified highly complex LIBOR-linked contracts that: (i) are issued overseas and not subject to the Adjustable Interest Rate (LIBOR) Act of 2021, and (ii) where no fallback language exists and/or transition via an amendment process is impracticable. It is likely that many of these contracts will now transition to a synthetic LIBOR.³
- *Operational Challenges Associated with June 30, 2023 Cessation Date.* Firms noted significant operational complexities associated with the conversion of LIBOR-linked contracts that will be transitioning, whether by hardwired fallback provisions, an amendment process, or the LIBOR Act for legacy contracts with no or impracticable fallback provisions (“tough legacy”). Firms recommended continued monitoring of the ARRC and other industry resources for guidance and tools in addressing these complexities.⁴

III. Conclusion

Firms have made significant efforts to prepare for the transition away from LIBOR, implementing a variety of practices depending on their business models and client base. Additionally, as noted above, several challenges exist to a smooth and orderly transition away from LIBOR. The Division encourages all firms to be aware of such issues, including consideration of the resources necessary to address them, and to act consistent with their fiduciary obligations as they continue in the transition process.

³ See [FCA Decision on Synthetic US Dollar LIBOR](#), March 4, 2022.

⁴ See, e.g., [ARRC Announcement of LIBOR Replacement Index Communication Tool](#), March 13, 2023.

This Risk Alert is intended to highlight for firms risks and issues that Division staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
