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THE END OF LIBOR

CONSIDERATIONS FOR INVESTMENT MANAGERS

The LIBOR transition encompasses far-ranging legal issues in the investment management space. Investment managers should consider the various implications and prepare now to mitigate regulatory and litigation risks as well as potential client-relationship issues. The checklist below includes top areas for consideration.

Industry focus has centered on the selection of an appropriate replacement reference rate, but one of the biggest areas of risk involves existing contracts. An essential step is to review existing agreements that will extend beyond 2021 to assess whether they have fallback language that adequately provides for implementation of a replacement reference rate if LIBOR is not available or not representative ("fallback language").

INVESTMENT MANAGER (IM) CONSIDERATIONS

- ☐ **Asset Selection and Recommendation:** Consider whether the IM continues to select or recommend assets for investors that have LIBOR-related risk. Does the IM advise clients as to products and portfolios that have embedded LIBOR risks?
- ☐ **New Offerings:** Consider whether the IM should cease buying or offering assets with LIBOR risk unless the related documents include effective fallback language. Develop and employ consistent due diligence procedures that require consideration of the fallback language.
  - Assess the LIBOR-related risks of newly issued fixed-income securities *before* acquiring them.
  - In funds holding *preferred* stock, assess the risk of buying and holding preferred stock that pays dividends tied to LIBOR.
- ☐ **Risk Mitigation for Accounts:** Assess the risks/benefits of shifting or divesting some LIBOR-related products to comparable non-LIBOR products where clients have large exposures.
- ☐ **Sweep Accounts:** Consider switching sweep accounts to money market funds that are not LIBOR based.
- ☐ **Assess and Manage Impact:** Develop and review internal procedures/policies for assessing the following on a regular basis:
  - The impact on expected interest payments, contract continuity, risks of volatility, and declining liquidity in LIBOR-based products.
  - Whether new products have effective fallback language or an applicable termination clause.
- ☐ **Outreach:** Appropriate channels should engage with sell-side counterparties and issuers of LIBOR-based securities, derivatives, and loans to discuss amending or otherwise converting these products and alternative reference rates.
  - Assess whether to terminate/exit transactions or adjust hedges that may become less advantageous as the end of LIBOR nears.
  - Consider whether contracts include callable features and assess them in the context of the end of LIBOR.

- ☐ **Potential Mitigation of Negative Impact on Fund Values and Liquidity:** For proprietary funds, evaluate whether IMs should reduce their funds' exposure to LIBOR-based assets. Document these analyses.
- ☐ **Pricing:** Consider how potential disruption in implementing a new reference rate and spread may impact *pricing* of legacy products in the portfolios. Document these analyses.

BENCHMARK ISSUES

- ☐ **Benchmark Determination:** Many funds use benchmarks that are based on LIBOR or are embedded with LIBOR. The *underlying benchmark* will need to transition to a new reference rate.
  - Consider whether a new benchmark is appropriate.
  - A revised or new benchmark should be communicated effectively to clients.
- ☐ **Measure of Performance Disclosures:** Where a fund's performance is based on comparisons of other funds whose underlying benchmarks are on LIBOR-based assets, the measure of performance results may be skewed, particularly if the transition among different products is handled in different ways. Consider disclosures to clients concerning this risk. The change in the benchmark may create anomalies in calculation of fees and could lend itself to disputes with investors.
- ☐ **Role as Calculating Party:** Does the IM pay or receive amounts dependent on LIBOR-based rates? Does the IM determine a LIBOR-based rate and related amounts payable by its clients or by others? Consider potential conflicting roles when acting as calculating agent.
- ☐ **Fees:** If clients are paying fees based on the IM's performance against a LIBOR-related benchmark, when the benchmark changes due to the LIBOR transition, the change in target numbers may create litigation risk. Investors may claim that fees are inflated under the new benchmark. Consider appropriate disclosures to investors of the impact a changing benchmark may have on fees.
- ☐ **Consider Potential Conflicts of Interest:** Avoid client perception of conflicts if the IM keeps investors invested in the IM's branded LIBOR-based funds or products, for which the IM earns fees.

COMMUNICATIONS/OUTREACH/DISCLOSURES

- ☐ **Disclosures:** Client communications should be clear, fair, and not misleading. Alternate options should be reasonable and fairly presented, including their risks, benefits, and costs. Disclosures must explain the differences between and implications of alternate rates (SOFR, SONIA, Zombie LIBOR, etc.). Consider appropriate differences in communications between sophisticated clients and retail clients regarding LIBOR-related disclosures.
- ☐ **Consistent Messaging:** Develop consistent messaging regarding the LIBOR transition for clients from all touch points of the IM.
- ☐ **Documented Planning:** Plan and implement increased engagement and client-specific conversations in the lead-up to the LIBOR transition and as you make decisions on dealing with the risks.

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FOR MORE INFORMATION

Morgan Lewis has an interdisciplinary team of partners involved in industry efforts and focused on advising clients on the best practices for minimizing risk and disruption associated with the LIBOR transition. If you have any questions or would like more information on the issues discussed herein, please contact any member of our team.

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