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FIA VIRTUAL LAW & COMPLIANCE CONFERENCE 2020

AROUND THE WORLD IN 60 MINUTES: GLOBAL DEVELOPMENTS

REGULATORY DEVELOPMENTS IN THE MOST IMPORTANT NUMBER: LIBOR

By

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1. Background: IBOR Transition

Key interbank offered rates (**IBORs**) are undergoing a period of change as regulators have recommended that firms consider adoption of alternative, overnight and generally risk-free rates (**RFRs**). In the case of the London Interbank Offered Rate (**LIBOR**), the UK Financial Conduct Authority (**FCA**) has announced that it will not compel or persuade LIBOR panel banks to make LIBOR submissions after the end of 2021, calling into question LIBOR's existence after that date and accelerating efforts to adopt alternative RFRs and fully transition away from LIBOR before it may cease.[1] Similar statements have been made by other global regulators in respect of certain other IBORs or reference rates. The FCA has also announced that markets need to prepared for potential announcements that some or all LIBOR settings are or will no longer going to be representative.

Authorities and industry working groups have been working to identify RFRs to serve as alternatives to the relevant corresponding IBORs. For instance, in the United States (**U.S.**) the Alternative Reference Rates Committee (**ARRC**) formed by the Federal Reserve Board and the New York Fed has identified the Secured Overnight Financing Rate (**SOFR**) as the replacement for U.S. Dollar (**USD**) LIBOR and it has published various milestones in its Paced Transition Plan[2], in addition to publishing model contractual provisions for new and legacy contracts, recommended best practices and other materials to assist market participants as they prepare for the cessation[3] of USD LIBOR.[4] Working groups in other jurisdictions, such as Australia, Canada, the European Union (**EU**), Hong Kong, Japan, and the United Kingdom (**UK**) have made similar advances in relation to other IBORs.

There are two main cross-border themes related to IBOR transition which this paper seeks to address as between the EU, UK,[5] and the U.S.:

(a) regulatory relief that has been provided in respect of certain EU, UK, and U.S. regulatory obligations applicable to swaps that may be triggered through certain actions by market participants as they seek to transition / amend legacy contracts as part of the transition process; and

(b) proposed legislative solutions to address "tough legacy" contracts. As more fully discussed in section 3 below, "tough legacy" contracts generally refers to those contracts (derivatives or otherwise) in respect of which the transition away from LIBOR is particularly difficult. Such contracts may be impossible or very difficult to amend, thus requiring some legislative intervention.

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1 *See* Speech by Andrew Bailey, Bloomberg London (July 27, 2017), available at https://www.fca.org.uk/news/speeches/the-future-of-libor.

2 **Paced Transition Plan** refers to the timeline and objectives published by ARRC that outlines key IBOR transition milestones until the end of 2021. *See* ARRC's Paced Transition Plan, available at https://www.newyorkfed.org/arrc/sofr-transition#pacedtransition.

3 Unless the context otherwise requires, references to "cessation" in this paper include "pre-cessations".

4 *See* ARRC Recommended Best Practices for Completing the Transition from LIBOR (May 27, 2020), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf.

5 The scope of this paper does not address in detail the implications of the withdrawal of the UK from the EU in the context of IBOR transition (**Brexit**).

2. Regulatory Relief Related to IBOR Transition

2.1

The vast majority of interest rate derivatives contracts incorporate either the ISDA 2006 Definitions or the ISDA 2000 Definitions, neither of which contain adequate fallback provisions that would apply in the event of an IBOR cessation. Both sets of definitions provide for an express fallback to a dealer poll where the "Calculation Agent" is required to seek quotations for the relevant IBOR, and it is generally understood that such dealer poll process would not yield a result following IBOR cessation. At the request of the Financial Stability Board's Official Sector Steering Group, the International Swaps and Derivatives Association (**ISDA**) has therefore been working to implement industry standard fallbacks for certain IBORs into legacy derivative contracts. As part of this effort, ISDA will soon publish the ISDA 2020 IBOR Fallbacks Protocol (**IBOR Fallbacks Protocol**) "to facilitate inclusion of the new fallbacks in existing non-cleared IBOR derivatives transactions between counterparties that both adhere to the protocol."[6] When parties adhere to the protocol, they agree that their legacy derivatives contracts will include new fallbacks in the event of a permanent cessation of relevant IBORs and, in some cases, in the event of a "pre-cessation" of relevant IBORs.[7] ISDA is also planning to publish bilateral forms of amendment that parties may use to amend their legacy contracts in lieu of the IBOR Fallbacks Protocol, as well as other documentation, including in relation to new interest rate derivatives..

There is a potentially a wide range of contractual amendments that may need to be made in order to transition away from IBORs (as well as other related amendments) such as:

(a) bilateral amendment to a contract to introduce fallbacks for IBOR cessation or pre-cessation (including through the use of the IBOR Fallbacks Protocol) or an amendment to replace the IBOR directly with a new RFR;

(b) consequential amendments to address the differences in valuation (e.g. via a spread adjustment) or as a result of the mechanical differences between an IBOR, which is generally a forward looking term rate and a RFR[8], which is a backward looking overnight rate;

(c) an amendment to the collateral/credit support document to replace the existing overnight rate or IBOR with an RFR; and

(d) an amendment to the terms of "non-linear products" that are impacted by the cessation of IBOR and transition to RFRs more generally. In relation to swaptions that could include amendments to address the change in the "Discount Rate" at the related clearing house, to incorporate Supplement 64 to the 2006 ISDA Definitions[9] and/or provide for compensation in relation to the change in "Discount Rate."[10]

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6 *See* ISDA Board Statement on Adherence to the IBOR Fallback Protocol (July 29, 2020), available at https://www.isda.org/2020/07/29/isda-board-statement-on-adherence-to-the-ibor-fallback-protocol/.

7 A 'pre-cessation' event is a public statement or publication of information by the regulatory supervisor for the administrator of LIBOR (currently, the FCA) announcing that (i) the regulatory supervisor has determined that LIBOR in the relevant currency is no longer, or as of a specified future date will no longer be, representative of the underlying market and economic reality that LIBOR in the relevant currency is intended to measure and that representativeness will not be restored, and (ii) it is being made in the awareness that the statement or publication will engage certain contractual triggers for fallbacks activated by pre-cessation announcements by such supervisor (howsoever described) in contracts. We note that following discussions and correspondence with ISDA and the FCA, on January 27th, 2020 LCH initiated a consultation process regarding the inclusion of a pre-cessation trigger in its Rulebook for cleared swaps linked to certain IBORs and is currently progressing with the implementation of such triggers based on the feedback received through that process.

8 Parties may choose to affect IBOR transition and related amendments through additional mechanisms (for example, through the use of a **Basis Swap Method** which means the use of one or more new basis swaps that would swap the entire IBOR basis of a portfolio with an alternative reference rate basis without amending any of the swaps referencing IBOR). The focus of this paper is not with respect to such mechanisms; however, please note that the terms of relief may vary depending on which mechanism is used.

9 *See* Supplement 64 to the 2006 ISDA Definitions, available at https://www.isda.org/a/X67TE/Supplement-64-to-the-2006-ISDA-Definitions.pdf.

10 Parties will likely need to make additional or different amendments to other "non-linear" derivatives to deal with any potential value transfers or other economic consequences on such products caused by IBOR transition. A consideration of the issues specific to non-linear products are out of scope for purposes of this paper.

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As part of the ARRC's Paced Transition Plan, on October 19th, 2020 LCH and the Chicago Mercantile Exchange (**CME**) will transition the rate at which they discount certain USD discounted cleared contracts from Fed Funds[11] to SOFR and both clearing houses will implement certain compensation mechanisms to address the impacts of such a transition. As a result of such transition, the value of certain physically and cash settled USD denominated swaptions is impacted, and parties may therefore need, or wish, to make amendments to such swaptions to address this as described in (d) above. In the EUR market, LCH, CME and other major clearing houses transitioned from the Euro Overnight Index Average (**EONIA**) to the euro short-term rate (**ESTR)** discounting on July 27th, 2020. Equally, parties may wish to adjust their bilateral collateral arrangements to reflect these changes at the clearing houses as described in (c) above.

Each of the changes to the contracts described above can be effected through a variety of methods, including but not limited to amendments to existing contracts, termination and the entry into of new contracts as well as macro and portfolio hedges.

Concerns about whether the amendments referred to above could trigger regulatory requirements applicable to swaps would potentially create significant barriers to a successful transition. Regulators and market participants are therefore working together to develop regulatory and interpretive relief to promote greater certainty and stability across financial markets in the context of the transition.

Below is a summary of the current relief provided by regulators in the EU, UK, and U.S. to date. We would encourage market participants to focus on the details and differences beyond this summary as they consider their transition strategy for derivatives and what relief might be available for their particular circumstances..

2.2 European Union

(a) Letter by the European Commission to the working group on euro risk-free rates (October 2, 2019)

This is a general letter relating to contractual continuity in the context of benchmark reform and IBOR transition. Therefore whilst no specific proposals can be pointed to, the general messaging is that regulation should not be perceived as standing in the way of contractual continuity. The European Commission (**EC**) recognises the importance of improving the robustness of contracts to benchmark related contingencies in line with the EU Benchmark Regulation (EU) 2016/1011 (**BMR**) and the International Organization of Securities Commissions' recommendations and supports the introduction of fallback provisions nominating an alternative reference rate.[12]

(b) Proposal to amend EMIR Level 1 through the CCP Recovery and Resolution Regulation (September 2020)[13]

Political agreement on the text of this proposed regulation was reached by the European Council and the European Parliament in June 2020 but has not yet been adopted by the EU Parliament and the EU Council or published in the Official Journal of the European Union. While the regulatory relief seeks to clarify that clearing and margin requirements should not apply if derivative contracts are "novated" for the purpose of replacing interest rate benchmarks or for the purpose of insertion of fallback provisions in relation to that benchmark, the scope and effectiveness of this relief is unclear as it refers to contracts being "novated". There is currently no definition of 'novation' in the relevant legislation and so whether this can be construed widely enough to cover adherence to the IBOR Fallbacks Protocol is an open question to be determined under EU law.

[11] **Fed Funds** means the target interest rate set by the Federal Reserve System's Federal Open Market Committee at which commercial banks borrow and lend their excess reserves to each other overnight.

[12] https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/shared/pdf/20191016/2019-10-16_WG_on_euro_RFR_meeting_Item_9_Reply_letter_EU_Commission_on_EMIR_requirements_in_the_context_of_the_benchmarks_reform.pdf

[13] https://www.consilium.europa.eu/media/41614/st14540-ad01-en19.pdf

(c) **Statement of support by European Securities and Markets Authority (ESMA) (December 5, 2019)**[14]

The European Supervisory Authorities (**ESAs**) are of the view that amendments made to legacy uncleared over-the-counter derivative contracts for the sole purpose of introducing fallbacks should not create new obligations on those legacy contracts; in particular, margin requirements and the clearing obligation should not apply where the legacy trade was not subject to these requirements before the introduction of fallbacks.

2.3 United Kingdom

(a) Statement of support by Bank of England Prudential Regulation Authority (December 18, 2019)[15]

The Prudential Regulation Authority (**PRA**) stated that international regulators had already made clear that the new margin and clearing requirements are not intended to apply to legacy contracts where such contracts were amended solely to deal with interest rate benchmark reforms. From an EU perspective, the PRA also noted that the ESAs had also confirmed their commitment to the approach taken by the international regulators. The PRA noted that it was strongly supportive of such clarifications.

(b) Bank of England Prudential Regulation Authority statement on LIBOR transition and PRA resolution-related rules (July 7, 2020)[16]

This statement indicates that the PRA has been considering the issues raised by the Working Group on Sterling Risk-Free Reference Rates, including possible implications of benchmark rate reform for rules related to resolution.

The PRA state that firms may need to consider whether existing contracts in scope of the Contractual Recognition of Bail-In (**CROB**) and Stay in Resolution (**Stays**) Parts of the PRA Rulebook that are changed to reflect the transition away from LIBOR could be considered materially amended, and thus required to include CROB and Stays terms.

The PRA considers that, where the sole purpose of an amendment to a liability (as defined in CROB) or a financial arrangement (as defined in Stays) is to transition away from LIBOR, the amendment should not be considered a material amendment as the term applies to either the CROB Part or the Stays Part of the PRA Rulebook.

Nonetheless, firms should consider adding CROB and Stays terms into the documentation for a third-country law governed liability or financial arrangement that is amended for the sole purpose of transitioning away from LIBOR, as it enhances firm resolvability. CROB and Stays are part of the UK resolution regime, ensuring that firms can fail in an orderly way. Both sets of rules are needed for the effectiveness of UK resolution actions in third-country jurisdictions.

2.4 United States

(a) Commodity Futures Trading Commission (CFTC)

On August 31, 2020, the CFTC's Division of Swap Dealer and Intermediary Oversight (**DSIO**), the Division of Market Oversight (**DMO**), and the Division of Clearing and Risk (**DCR**) each issued no-action letters (**NALs**) providing certain, in some instances time limited and conditional no-action relief to swap dealers and other market participants related to the industry-wide initiative to transition from swaps that reference LIBOR and

14 https://www.esma.europa.eu/sites/default/files/library/esas_2019_19_statement_on_the_introduction_of_fallbacks_in_otc_derivative_contracts_to_increase_contract_robustness.pdf

15 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/prudential-regulatory-framework-and-libor-transition.pdf?la=en&hash=55018BE92759217608D587E3C56C0E205A2D3AF4

16 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/prudential-regulatory-framework-and-libor-transition.pdf?la=en&hash=55018BE92759217608D587E3C56C0E205A2D3AF4

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other IBORs to swaps that reference RFRs. The NALs expand and clarify the relief originally provided in December 2019 (**Original Relief**); and supersede in their entirety the Original Relief.[17]

The NALs were drafted in response to a request from the ARRC that no-action relief be provided for non-compliance with certain CFTC regulations applicable to swaps under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (**Dodd-Frank**) primarily in connection with amending uncleared swaps referencing (i) in-scope IBORs (as more fully described below in relation to each NAL), (ii) any other interest rate that the parties to a swap reasonably expect to be discontinued or reasonably determine has lost its relevance as a reliable benchmark due to a significant impairment, or (iii) any other reference rate that succeeds any of the rates described in (i) or (ii) (collectively, **IRRs**).[18]

The relief each division provided is as follows:

(i) **NAL 20-23**[19]

The DSIO letter amends and restates relief primarily related to Part 23 of the CFTC regulations (i.e. relief for swap dealer-related requirements such as registration *de minimis* requirements, uncleared swap margin rules, business conduct requirements, confirmation, documentation, and reconciliation requirements, and certain other eligibility requirements) originally granted in NAL 19-26.[20] Unlike the DCR no-action relief and the DMO no-action relief (discussed below), the DSIO no-action relief is not generally time limited. The following is a summary of in-scope amendments, IBORs and regulatory obligations under NAL 20-23:

NAL 20-23 – Covered Amendments

Relief under NAL 20-23 addresses amendments made to uncleared swaps that solely consist of (A) a Qualifying IRR Amendment;[21] (B) a Qualifying Swaption Amendment;[22] (C) a Qualifying CSA Amendment;[23] or (D) any combination of the foregoing (a **Qualifying Amendment**).

NAL 20-23 – Conditions to Relief

For purposes of NAL 20-23, a Qualifying Amendment **may not**, beyond what is necessary to accommodate the differences in market conventions for an IRR or discount rate used by a central counterparty and its replacement, (A) extend the maximum maturity of a swap or a .portfolio of swaps, or (B) increase the total effective notional amount of a swap or the aggregate total effective notional amount of a portfolio of swaps.

A Qualifying Amendment **may include** amendments to existing trade terms to conform to different market conventions, resulting, for example, in different reset dates, fixed/floating leg payment dates, business day conventions, and day count fractions. The relief also includes amendments to commercial arrangements "referencing an IRR may include ancillary changes to existing terms to conform to

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17 NAL 20-23, NAL 20-24 and NAL 20-25 supersede in their entirety NAL 19-26, NAL 19-27 and NAL 19-28, respectively.

18 The CFTC typically provides relief one of two ways: (1) when making an amendment to a legacy contract; or (2) when determining the availability of a certain exemption.

19 *See* NAL 20-23, available at https://www.cftc.gov/csl/20-23/download.

20 *See* NAL 19-26, available at https://www.cftc.gov/csl/19-26/download.

21 **Qualifying IRR Amendment** means an "amendment of an uncleared swap that references an IRR solely to: (1) include new fallbacks to alternative reference rates triggered only by permanent discontinuation of an IRR or determination that an IRR is non-representative by the benchmark administrator or the relevant authority in a jurisdiction; or (2) accommodate the replacement of an IRR." *See* NAL 20-25, available at https://www.cftc.gov/csl/20-23/download.

22 **Qualifying Swaption Amendment** means "if, solely as a result of a public announcement by a [derivatives clearing organization] of an impending change the discount rate used for purposes of valuing cleared swaps and the rate applied to collateral or settlement amounts relating to certain cleared swaps, the counterparties to a swaption either: (1) voluntarily exchange compensation for a swaption; or (2) amend a swaption's terms solely to reflect an agreement regarding the discount rate used by a central counterparty…, then such actions under (1) or (2) shall be referred to as a Qualifying Swaption Amendment." *See* NAL 20-25, available at https://www.cftc.gov/csl/20-23/download.

23 **Qualifying CSA Amendment** means "an amendment to a [Collateral Support Annex (**CSA**)] solely to (1) align the interest rate paid on posted collateral for uncleared swaps under a CSA with the discount rate used by a [central counterparty]; or (2) replace an [in-scope IBOR for purposes of NAL 20-23 set forth herein] that is an interest rate paid on posted collateral for uncleared swaps, is referred to as a Qualifying CSA Amendment." *See* NAL 20-25, available at https://www.cftc.gov/csl/20-23/download.

different market conventions for an IRR and any alternative rate" as well as entering into new basis swaps that swap the entire IRR basis of a portfolio with an alternative rate basis without amending the swaps referencing IRRs.[24]

NAL 20-23 – Covered IBORs

Relief under NAL 20-23 addresses the following IBORs:

(A) without limitation: LIBOR,[25] Tokyo Interbank Offered Rate (**TIBOR**), Bank Bill Swap Rate (**BBSW**), Singapore Interbank Offered Rate (**SIBOR**), Canadian Dollar Offered Rate (**CDOR**), Euro Interbank Offered Rate (**EURIBOR**), and Hong Kong Interbank Offered Rate (**HIBOR**);

(B) any other interest rate that the parties to a swap reasonably expect to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment; and

(C) any other reference rate that succeeds any of the foregoing.

NAL 20-23 – Covered Obligations

Relief under NAL 20-23 addresses the following regulatory obligations:

– **De Minimis Exception to the Swap Dealer Definition** – The DSIO will not recommend enforcement action against any person for failure to include a swap in its calculations under the *de minimis* threshold for swap dealer (**Swap Dealer**) designation and registration under section 1a(49)(D) of the Commodity Exchange Act (**CEA**) to the extent such swap would be required to be included as a consequence of a Qualifying Amendment to such swap.

– **Uncleared Swap Margin Requirements** – Swap Dealers that are not prudentially regulated are subject to the uncleared swap margin requirements promulgated by the CFTC pursuant to section 4s(e) of the CEA (the **CFTC Margin Rule**) that make amendments to their uncleared legacy swaps after the applicable compliance date may bring swaps entered into prior to an applicable compliance date (**Legacy Swaps**) in scope for purposes of the CFTC Margin Rule. The DSIO will not recommend that the CFTC take an enforcement action against a Swap Dealer for a failure to comply with the CFTC Margin Rule solely to the extent such compliance would be required as a consequence of making a Qualifying Amendment to a CFTC Margin Rule legacy swap.

– **Business Conduct Requirements** – The business conduct standards under subpart H to Part 23 of the CFTC's regulations (meaning rules promulgated by the CFTC, found in Title 17 Chapter 1 of the Code of Federal Regulations) (**CFTC Rule(s)**) require a Swap Dealer to provide or obtain specific information from their counterparties, to obtain specific representations in writing, and to perform certain due diligence inquiries prior to entering into (or offering to enter into) a swap with such counterparties (**Counterparty BCS**). The CFTC has previously noted that the Counterparty BCS will not apply to swaps executed before the effective date of the Counterparty BCS rules if the requirement does not impose an ongoing duty on the swap dealer (such swaps, **Counterparty BCS Legacy Swaps**). However, the CFTC also stated that if Counterparty BCS Legacy Swaps were materially amended, such swaps would be subject to the requirements of the Counterparty BCS as if they were new swaps. The DSIO will not recommend that the CFTC take an enforcement against a Swap Dealer for a failure to comply with the Counterparty BCS (excluding CFTC Rule 23.431(a), but including the mid-

[24] *See* Footnote 7 above.

[25] LIBOR is defined generically as the "London Interbank Offered Rate" in NAL 20-23 and should therefore cover all five LIBOR currencies, although note there is a technical drafting difference between the in-scope IBORs under NAL 20-24 and NAL 20-25 and it is likely that they substantively cover the same LIBORs.

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market mark CFTC Rule 23.431(a)(3)(i)),[26] solely to the extent such compliance would be required as a consequence of a Qualifying Amendment to an uncleared Legacy Swap or Pre-Transition Swap[27].

– **Documentation and Swap Processing Requirements** – The DSIO will not recommend that the CFTC take an enforcement action against a Swap Dealer for a failure to comply with (A) the confirmation requirement under CFTC Rule 23.501 solely due to a Qualifying Amendment to an uncleared Legacy Swap or Pre-Transition Swap, (B) a failure to comply with the swap trading relationship documentation requirement under CFTC Rule 23.504 solely to the extent such compliance would be required as a consequence of a Qualifying Amendment to an uncleared Legacy Swap, or (C) a failure to comply with the discrepancy resolution timing requirements of CFTC Rules 23.502(a)(4) and (b)(4) solely to the extent such compliance would be required as a consequence of a Qualifying Amendment to an uncleared Legacy Swap or Pre-Transition Swap.

– **Relief Requested Related to End-Users**

Exemptions/Exceptions from the Margin Rule

The DSIO will not recommend that the CFTC commence an enforcement action against a Swap Dealer for a failure to comply with the CFTC Margin Rule[28] with respect to a Covered IRS[29] entered into with an Eligible End-User[30] if compliance with the CFTC Margin Rule would be required solely due to a Qualifying Amendment to such Covered IRS, or, with respect to the related commercial arrangement upon which an Eligible End-User is relying for purposes of electing an exception or exemption from the Clearing Requirement,[31] solely as a consequence of a Qualifying Amendment to such Covered IRS, or, with respect to the related commercial arrangement upon which an Eligible End-User is relying for purposes of electing an exception or exemption from the Clearing Requirement, solely as a consequence of an amendment to such commercial arrangement solely for the purpose of: (A) including new fallbacks to alternative reference rates triggered only by the permanent discontinuation of an IRR or determination that an IRR is non-representative by the benchmark administrator or the relevant authority in a jurisdiction; or (B) accommodating the replacement of an IRR.

Status as ECPs

The DSIO will not recommend that the CFTC commence an enforcement action against any person for a failure to comply with section 2(e) of the CEA or to qualify as an eligible contract participant pursuant to section 1a(18) of the CEA solely to the extent such status is relevant as a consequence of a Qualifying Amendment to an uncleared swap.

End-User Documentation Requirements

The DSIO will not recommend that the CFTC commence an enforcement action against a Swap Dealer for failure to obtain documentation meeting the requirements of CFTC Rule

[26] Note that this relief does not extend to CFTC Rule 23.431(a), which requires a Swap Dealer to provide material information concerning the risks and characteristics of a swap to its counterparty at a reasonably sufficient time prior to entering into the swap, except for the requirement to provide the mid-market mark of the swap in CFTC Rule 23.431(a)(3)(i). ISDA plans to publish disclosures related to CFTC Rule 23.431(a).

[27] **Pre-Transition Swaps** mean uncleared swaps, including, where relevant, Legacy Swaps, that were entered into prior to the effective date of a Qualifying IRR Amendment, Qualifying Swaption Amendment, or Qualifying CSA Amendment.

[28] *See* 17 CFR 23.150-159, 161.

[29] **Covered IRS** generally means any interest rate swap that (1) qualified as a swap used to hedge or mitigate commercial risk pursuant to CFTC Rule 50.50(c) at the time of execution; (2) qualified as a swap for which an Eligible End-User (a) elected an exception or exemption from the IRS Clearing Requirement pursuant to rules 50.50, 50.51, or any prior no-action position taken by the DCR; and (b) notified its swap counterparty of such an election; and (3) was reported to a swap data repository at the time an applicable exception or exemption was elected, pursuant to rules 50.50(a)(1)(iii), 50.51, or an applicable condition in a prior DCR staff letter.

[30] **Eligible End-User** generally refers to the following types of entities: (1) a non-financial entity electing an exception under CFTC Rules 50.50(a)-(c); (2) a financial entity electing an exception under CFTC Rules 50.50(a)-(d); (3) an exempt cooperative electing an exemption under CFTC Rule 50.51; and (4) an entity identified by the CFTC in its recent notice of proposed rulemaking under proposed rules 50.77 (community development financial institutions), 50.78 (bank holding companies), and 50.79 (savings and loan holding companies).

[31] *See* 17 CFR Part 50.

23.505(a)(4) from an Eligible End-User for which it has previously obtained such documentation solely to the extent such would be required as a consequence of a Qualifying Amendment to an uncleared swap.

(ii) **NAL 20-24**[32] **–** The DMO letter amends and restates relief related to the trade execution requirement under CEA section 2(h)(8) originally granted in NAL 19-27.[33] The DMO no-action relief is time limited until December 31, 2021. The following is a summary of in-scope amendments, IBORs and regulatory obligations under NAL 20-24:

NAL 2024 – Covered Amendments

Relief under NAL 20-24 addresses: (A) new swaps that reference RFRs (**New RFR Swaps**); (B) Fallback Amendments;[34] and (C) Replacement Rate Amendments[35] (each, an **IBOR Transition Mechanism**).

NAL 20-24 – Conditions to Relief

For purposes of NAL 20-24, IBOR Transition Mechanism will not include any amendment that (A) extends the maximum maturity of a swap or a portfolio of swaps beyond what is necessary to accommodate the differences between market conventions for an IBOR and its replacement RFR, or (B) increases the total effective notional amount of a swap or the aggregate total effective notional amount of a portfolio of swaps beyond what is necessary to accommodate the differences between market conventions for an IBOR and its replacement RFR.

An IBOR Transition Mechanism **may include** a number of ancillary changes to existing trade terms to conform to different market conventions, resulting, for example, in different reset dates, fixed/floating leg payment dates, business day conventions, day count fractions, and the like.

NAL 20-24 – Covered IBORs

Relief under NAL 20-24 addresses the following IBORs:

(A) without limitation: USD LIBOR, GBP LIBOR, JPY LIBOR, TIBOR, BBSW, SIBOR, CDOR, EURIBOR, and HIBOR;

(B) any other interest rate that the parties to a swap reasonably expect to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment; and

(C) any other reference rate that succeeds any of the foregoing.

NAL 20-24 – Covered Obligations

Relief under NAL 20-24 addresses the following regulatory obligations:

– **Trade Execution Requirement** – Until December 31, 2021, the DMO will not recommend that the CFTC commence an enforcement action against any person for a failure to comply with the trade execution requirement under section 2(h)(8) of the CEA, with respect to an IBOR-linked swap that is amended or created by an IBOR Transition Mechanism, for the sole purpose of accommodating the replacement of the applicable IBOR with an RFR. As stated in the letter, "DMO is providing this time limited no-action relief to further regulatory certainty,

[32] *See* NAL 20-24, available at https://www.cftc.gov/csl/20-24/download.

[33] *See* NAL 19-27, available at https://www.cftc.gov/csl/19-27/download.

[34] **Fallback Amendments** means "amendments of IBOR-linked swaps to include fallbacks to new RFRs that are triggered when the applicable IBOR is unavailable, permanently discontinued, or is determined to be non-representative by the benchmark administrator or the relevant authority in a jurisdiction – including such amendments that are effected by the ISDA protocol process."

[35] **Replacement Rate Amendments** means voluntarily amending "IBOR-linked swaps to reference RFRs prior to the cessation of the applicable IBOR." For the avoidance of doubt, Replacement Rate Amendments include Qualifying Swaption Amendments and Qualifying CSA Amendments, as defined above.

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and to provide flexibility to help market participant's transition from IBORs to RFRs in a manner that accounts for individual circumstances. The DMO is not opining on whether any particular IBOR Transition Mechanism, including any particular Fallback Amendment or Replacement Rate Amendment, may otherwise trigger the trade execution requirement under CEA section 2(h)(8)."

(iii) **NAL 20-25[36] –** The DCR letter amends and restates relief related to the clearing requirement and related exceptions originally granted in NAL 19-28.[37] The DCR no-action relief is time limited and extends until December 31, 2021. The following is a summary of in-scope amendments, IBORs, and regulatory obligations under NAL 20-25.

NAL 20-25 – Covered Amendments

Relief under NAL 20-25 addresses the amendment of an Uncleared Legacy IRS[38] or an Uncleared Legacy Swaption[39] that solely consists of a Qualifying Amendment.

NAL 20-25 – Conditions to Relief

For purposes of NAL 20-25, a Qualifying Amendment may not include any amendment that (A) changes the counterparties to the original Uncleared Legacy IRS or Uncleared Legacy Swaption, (B) extends the maximum maturity of a Uncleared Legacy IRS or Uncleared Legacy Swaption or a portfolio of such swaps beyond what is necessary to accommodate the differences between market conventions for an IRR or discount rate used by a CCP and its replacement, or (C) increases the total effective notional amount of a Uncleared Legacy IRS or Uncleared Legacy Swaption or the aggregate total effective notional amount of a portfolio of such swaps beyond what will accommodate the differences between market conventions for an IRR or a discount rate used by a CCP and its replacement.

A Qualifying Amendment to an Uncleared Legacy IRS or Uncleared Legacy Swaption may include ancillary changes to existing trade terms to conform to different market conventions, resulting, for example, in different reset dates, fixed/floating leg payment dates, business day conventions, and day count fractions.

NAL 20-25 – Covered IBORs

Relief under NAL 20-25 addresses the following IBORs:

(A) without limitation: USD LIBOR, GBP LIBOR, JPY LIBOR, TIBOR, BBSW, SIBOR, CDOR, EURIBOR, and HIBOR;

(B) any other interest rate that the parties to a swap reasonably expect to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment; and

(C) any other reference rate that succeeds any of the foregoing.

NAL 20-25 – Covered Obligations

Relief under NAL 20-25 addresses the following regulatory obligations:

– **IRS Clearing Requirement** – Until December 31, 2021, the DCR will not recommend that the CFTC take an enforcement action against any person for a failure to comply with the IRS Clearing Requirement under section 2(h)(1)(A) of the CEA and CFTC Rules 50.2 and 50.4(a)

[36] *See* NAL 20-25, available at https://www.cftc.gov/csl/20-25/download.

[37] *See* NAL 19-28, available at https://www.cftc.gov/csl/19-28/download.

[38] **Uncleared Legacy IRS** means "interest rate swaps that otherwise would be required to be cleared pursuant to section 2(h)(1)(A) of the CEA and [CFTC] regulations 50.2 and 50.4(a), but for the fact that such swaps were entered into prior to an applicable compliance date."

[39] **Uncleared Legacy Swaption** means a "swaption that, upon exercise, would result in an [interest rate swap (**IRS**)] of a type subject to the CFTC's IRS Clearing Requirement, but where the swaption was executed prior to the relevant compliance date on which such an IRS would have been required to be cleared, but amended after an applicable compliance date."

when such person makes a Qualifying Amendment to an Uncleared Legacy IRS or Uncleared Legacy Swaption, provided that such an amendment is made for the sole purpose of transitioning from an IRR to an alternative reference rate.

- **Eligible End-User Representations, Reporting, and Ongoing Monitoring** – The DCR will not recommend that the CFTC commence an enforcement action against an Eligible End-User making a Qualifying Amendment to a Covered IRS, for a failure to comply with sections 2(h)(1)(A) and 2(h)(7) of the CEA, and CFTC Rules 50.2, 50.4(a), 50.50, 50.51, or any applicable conditions in prior DCR staff letters, when such an Eligible End-User is relying on prior representations made to their swap counterparties at the time such end-users originally elected an exception or exemption from the IRS Clearing Requirement, provided such a Qualifying Amendment is made for the sole purpose of transitioning from an IRR to an alternative rate.

Similarly, the DCR will not recommend an enforcement action against Eligible End-Users for failure to monitor ongoing compliance with an election of exception or exemption from the Clearing Requirement, including pursuant to the requirements under CFTC Rules 50.50(b)(2), 50.50(c), 50.51, or any applicable conditions in prior DCR staff letters when entering into a Qualifying Amendment to a Covered IRS, provided such a Qualifying Amendment is made for the sole purpose of transitioning from an IRR to an alternative reference rate.

(b) Prudential Regulators

(i) Final Rule on Margin and Capital Requirements for Covered Swap Entities[40]

On June 25, 2020, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, **Prudential Regulators**) issued a final rule to amend their regulations regarding the minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (**Amended PR Margin Rule**).

The Amended PR Margin Rule amends regulations requiring Swap Dealers to exchange margin with their counterparties for swaps that are not centrally cleared (**PR Margin Rule**).[41] The Amended PR Margin Rule permits swaps entered into prior to an applicable compliance date (legacy swaps) to retain their legacy status in the event that they are amended to replace an IBOR or amended in other specified way to address IBOR transition.[42]

The Amended PR Margin Rule permits various types of amendments to a legacy swap to accommodate ongoing developments toward a permanent replacement rate. Replacements could be carried out using a variety of legal mechanisms by permitting amendments accomplished by the parties' adherence to a protocol, another amendment of a contract or confirmation (including adherence to a protocol), or execution of a new contract in replacement of and immediately upon termination of an existing contract (i.e. tear-up), subject to certain limitations. An amendment could also replace an IBOR with a temporary interest rate and later replace the temporary interest rate with a permanent interest rate. The Prudential Regulators explained that there would be no limit to the number of such amendments.[43]

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40 *See* 85 FR 39754, Margin and Capital Requirements for Covered Swap Entities, available at https://www.fdic.gov/news/board/2020/2020-06-25-notice-dis-b-fr.pdf.

41 *See* Final Rule to Establish Margin and Capital Requirements for Covered Swap Entities, available at https://fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf.

42 Under the Amended PR Margin Rule, parties will also be allowed to "incorporate spreads or other adjustments to the replacement interest rate" in order to maintain the economics of the swap and "make other necessary technical changes to operationalize the determination of payments or other exchanges of economic value using the replacement interest rate, including changes to determination dates, calculation agents, and payment dates," provided that neither the maturity nor the total effective notional amount of the legacy swap is extended or increased "beyond what is necessary to accommodate the differences between market conventions for an outgoing interest rate and its replacement."

43 *Id.* at 39757.

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The foregoing relief under the Amended PR Margin Rule is limited to the following IBORs:

(A) LIBOR,[44] TIBOR, BBSW, SIBOR, CDOR, EURIBOR, and HIBOR;

(B) any other interest rate that a covered swap entity reasonably expects to be replaced or discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment; and

(C) any other interest rate that succeeds a rate referenced in (A) or (B) above.[45]

(c) Regulatory Obligations Without Relief

It is important to note that relief has not or not yet been expressly addressed in all cases. Examples of regulatory obligations where relief has **not** been expressly provided include but are not limited to:

- the mandatory trading obligation under MIFIR;[46]
- certain reporting obligations under Dodd-Frank, EMIR,[47] MiFIR,[48][49] and SFTR[50] (e.g. the trade repositories' reporting obligation under EMIR, the reporting obligation under EMIR (Article 9));
- the reporting obligation under SFTR, the transaction reporting obligation under MIFIR, and the post-trade transparency obligation under MIFIR); risk mitigation obligations under EMIR;[51]
- contractual recognition of resolution stay obligations under the U.S. Stay Regulations;[52]
- the re-use disclosure requirement under SFTR;
- settlement discipline requirements under CSDR.[53] and

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44 LIBOR is defined generically as the "London Interbank Offered Rate" in the Prudential Regulator relief and should therefore cover all five LIBOR currencies.

45 Note that an amendment made under this paragraph (c) could be one of multiple amendments. For example, an amendment could replace an IBOR with a temporary interest rate and later replace the temporary interest rate with a permanent interest rate.

46 The mandatory trading obligation in respect of derivatives transactions is set out in Article 28 of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, as amended from time to time (**MiFIR**) and the associated regulatory technical standard (Commission Delegated Regulation (EU) 2017/579 of June 13, 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on the direct, substantial and foreseeable effect of derivative contracts within the Union and the prevention of the evasion of rules and obligations, as amended from time to time), with the calibration of this obligation determined in accordance with Article 32 MiFIR and the associated regulatory technical standard (Commission Delegated Regulation (EU) 2016/2020 of 26 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on criteria for determining whether derivatives subject to the clearing obligation should be subject to the trading obligation) and the current list of relevant instruments subject to this obligation set out in a further regulatory technical standard (Commission Delegated Regulation (EU) 2017/2417 of November 17, 2017 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on the trading obligation for certain derivatives).

47 The reporting obligation is set out in Article 9 of EMIR and associated implementing and regulatory technical standards (Commission Delegated Regulation (EU) No 148/2013 of December 19, 2012 supplementing EMIR with regard to regulatory technical standards on the minimum details of the data to be reported to trade repositories and Commission Implementing Regulation (EU) No 1247/2012 of December 19, 2012 laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories according to EMIR, each as amended from time to time).

48 The transaction reporting obligation set out in Article 26 MiFIR and the associated regulatory technical standard (Commission Delegated Regulation (EU) 2017/590 of 28 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the reporting of transactions to competent authorities, as amended from time to time).

49 The post-trade reporting obligations set out in Articles 10 (in respect of trading venues) and 21 (in respect of investment firms) MiFIR and the associated regulatory technical standard (Commission Delegated Regulation (EU) 2017/583 of July 14, 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives, as amended from time to time).

50 The reporting obligation is set out under Article 4 of Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (**SFTR**).

51 The risk mitigation obligations are set out in Article 11 of EMIR and the associated regulatory technical standard (Commission Delegated Regulation (EU) No 149/2013 of December 19, 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP, as amended from time to time) and comprise portfolio reconciliation, timely confirmation, dispute resolution, and portfolio compression.

52 **U.S. Stay Regulations** means the regulations issued by the Board of Governors of the Federal Reserve System (12 C.F.R. §§ 252.2, 252.81-88), the Federal Deposit Insurance Corporation (12 C.F.R. §§ 382.1-7), and the Office of the Comptroller of the Currency (12 C.F.R. §§ 47.1-8).

53 Articles 6 and 7 of Regulation (EU) No 909/2014 of the European Parliament and of the Council of July 23, 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (**CSDR**) and associated regulatory technical standards (Commission Delegated Regulation (EU) 2018/1229 of May 25, 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline).

- obligations under Dodd-Frank that may be triggered by amendments in furtherance of BMR, which may go beyond IBOR transition.

It is unclear when or if regulators will provide relief for non-compliance with these regulations in connection with transitioning IBOR-linked legacy contracts. Even where relief is granted, there are differences in approach with respect to timing and granularity that may impact a firm's ability to manage the transition globally.

More generally, market participants need to carefully consider their transition strategy and whether they regard relief for a particular regulatory obligation as necessary. Asking for and/or obtaining relief may imply that the relief is necessary and that, absent such relief, the market believes the regulatory obligation in question would be triggered. This may be unhelpful in the future for market participants when faced with a similar fact patterns or if market participants have already taken interpretations of certain obligations and when they are triggered in other contexts or where regulators across jurisdictions take a different approach to the granularity and approach to relief, although clarifying that such request may be for clarification and certainty only in light of these important market events may be helpful.

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3. Legislative Solutions for "Tough Legacy" Contracts

3.1 Background: What are "tough legacy" contracts in the context of derivatives?

"Tough legacy" contracts refers to existing IBOR-referencing contracts that are unable, before the end of 2021, to either convert to a non-IBOR rate or be amended to add fallbacks. Although existing contracts may be amended, such an amendment process might be challenging, if not impossible, for certain products.

While many derivatives will not be tough legacy contracts, the adoption of the IBOR Fallbacks Protocol is voluntary. In addition, there are likely to be cases where a derivative is used to hedge an exposure which is itself considered tough legacy or forms part of a more complex structure, where the derivative is subject to the same or similar constraints as the instrument it is used to hedge, thus making the derivative tough legacy as well. Accordingly, while the regulators expect parties to pro-actively amend their derivatives positions and/or adopt fallbacks, various forms of legislative solutions have been proposed to address tough legacy scenarios. There are also significant tough legacy challenges for various reasons in other markets, such as floating rate notes, securitizations, loans and mortgages.

Tough legacy and the possible legislative responses to tough legacy issues is a rapidly evolving area in the EU, UK and U.S. and the scope of any proposed legislative solutions may be unclear and subject to change. As we discuss further below, even if solutions are ultimately adopted, market participants will need to consider various complexities inherent in those solutions from a scoping, conflicts of law and cross-product basis risk perspective.

3.2 European Union

A proposal to amend the EU BMR has recently been published by the EC[54] and looks primarily to provide a solution to the tough legacy challenges. The legislation is not yet in final form and is subject to trialogue negotiations between the EU institutions but indications to date are that the goal is for the proposals to be agreed, published in the Official Journal of the EU and applicable before end 2020. They would then form part of the UK onshored version of the BMR.

Whilst a number of aspects of the proposal remain unclear, the intention of the legislation appears to be to empower the EC to designate a statutory rate for a benchmark that will cease to be published where the cessation may result in significant disruption in the functioning of financial markets in the Union and where certain triggers relating to non-representativeness or cessation are satisfied. The replacement benchmark would by operation of law replace all references to the benchmark that has ceased in certain contracts that do not contain "suitable fallback provisions". In the EC's proposal, the scope of instruments covered by the proposal is limited to instruments in scope of the BMR where at least one party is an EU supervised entity but we understand the European Council is looking to widen this scope to all contracts.

3.3 United Kingdom

In a written statement on June 23, 2020 made by Rishi Sunak, the Chancellor of the Exchequer, the UK Government announced its intention to introduce a legislative solution for the transition of tough legacy LIBOR-linked products.[55]

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[54] *See* Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation, available at https://ec.europa.eu/finance/docs/law/200724-benchmarks-review-proposal_en.pdf.

[55] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS307/

In particular, the UK Government will introduce amendments to the BMR as amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018 (the **UK BMR**), to ensure that FCA powers are sufficient to manage an orderly transition from LIBOR.

The UK Government therefore intends to:

– Extend the circumstances in which the FCA may require an administrator to change the methodology of a critical benchmark and clarify the purpose for which the FCA may exercise this power. New regulatory powers would enable the FCA to direct a methodology change for a critical benchmark, in circumstances where the regulator has found that the benchmark's representativeness will not be restored and where action is necessary to protect consumers and/or to ensure market integrity.
– Strengthen existing law to prohibit use of an individual critical benchmark where its representativeness will not be restored, whilst giving the regulator the ability to specify limited continued use in legacy contracts.
– Refine ancillary areas of the UK's regulatory framework for benchmarks to ensure its effectiveness in managing the orderly wind down of a critical benchmark, including that administrators have adequate plans in place for such situations.

It intends to include measures in the forthcoming Financial Services Bill to ensure that, by end-2021, the FCA has the appropriate regulatory powers to automatically transition tough legacy contracts away from LIBOR without the need for bilateral or multilateral contractual amendment. The UK solution means that tough legacy LIBOR-linked contracts will continue to reference LIBOR – and as such there will be no direct amendment to those contracts. Instead of the current LIBOR methodology, "legislative LIBOR" will apply.

Furthermore, in the Bank of England's recent webinar for corporate borrowers, "Is your business prepared for LIBOR?", the FCA spoke publicly about their plans for ensuring the availability of a forward-looking term "modified LIBOR" as a means of addressing the tough legacy problem.[56] They emphasized that this would be a "one size fits all" solution only for the purposes of addressing tough legacy and was not intended for new products.

3.4 United States

(a) New York Legislative Solution

The ARRC has published a proposal for New York (**NY**) legislation to assist the transition of certain financial contracts governed by NY law which reference USD LIBOR.[57]

The proposed statute is designed to minimize costly and disruptive litigation by providing legal certainty for the issues that are likely to arise under NY law.[58] The proposed statute would:

(i) provide that, by operation of law, any contract that has a fallback based on USD LIBOR or no fallback will fallback to the recommended benchmark replacement plus spread adjustment;

(ii) prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of the discontinuance of USD LIBOR or the use of the statute's recommended benchmark replacement;

(iii) definitively establish that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to USD LIBOR; and

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[56] *See* Edwin Schooling-Latter, Financial Conduct Authority, at 19:45, available at https://www.youtube.com/watch?v=egJziWU8yAA.

[57] *See* the ARRC's Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf.

[58] According to the ARRC "…businesses in New York, [as well as the New York government] will, in a LIBOR cessation, be faced with legal uncertainty and economic impact on hundreds of thousands of affected financial contracts. Consumers in New York will also be affected by the discontinuance of LIBOR, which is referenced in adjustable rate mortgages, student loans, credit cards and other consumer products. In addition, investors in New York, including mutual funds and public pension funds holding LIBOR-based investments, will be adversely affected by the impact on the market value of their investments caused by this legal uncertainty. Without clarification by the proposed legislation, disputes arising out of these transactions will burden New York's courts."

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(iv) provide a safe harbor from litigation for the use of the recommended benchmark replacement. The proposed legislation would achieve these goals by requiring the use of the recommended benchmark replacement where the contract language is silent or the fallback provisions that provide for a benchmark replacement is based in any way on USD LIBOR.

Where the fallback provisions are discretionary, the proposed legislation's safe harbor is intended to encourage the selection of the recommended benchmark replacement. The proposed legislation, however, would not impact legacy contracts that fallback to a non-LIBOR replacement rate (such as the prime rate).

The proposed legislation would not generally cover loans as it would not alter existing fallback language that relies on a non-LIBOR rate (e.g. prime). Contractual fallback language for loans may include instructions to seek quotes from one reference bank or a set of reference banks in the event that LIBOR is not published, but if an offered rate is not obtained, then the language generally provides that the rate paid on these loans would convert to an alternative base rate – either the prime rate or a rate which is typically close to the prime rate. More recent loans, particularly in the syndicated loan market, provide a mechanism for the parties to select and implement a replacement benchmark; however, if the relevant consents are not achieved, then these loans would convert to an alternative base rate and the proposed legislation would leave an ultimate fallback to a non-LIBOR replacement rate (such as the prime rate) unaffected. According to the ARRC, this framework was intentional in light of disparate views in financial markets regarding the replacement interest rate for loans.[59]

In derivatives, the most common definition of LIBOR provides that if LIBOR is unavailable, the calculation agent has the contractual obligation to determine the rate by polling reference banks (first in London, then in NY). However, reference banks may be unlikely respond to a poll. The reference bank poll to recreate LIBOR after it no longer exists is therefore highly likely to fail. Instead of the fallback polling process that did not anticipate these issues, the proposed legislation would implement the recommended benchmark replacement, which could be consistent with the adjusted rate proposed in the IBOR Fallback Protocol.

Furthermore, the proposed legislation has been identified to benefit commercial end users (i.e., those that have operational and other hurdles to adhering to protocols) by reducing the uncertainty embedded in their derivatives contracts. Accordingly to the ARRC, it would increase consistency across derivatives markets about the value of derivatives linked to USD LIBOR, align with the floating rate note and securitization markets that use derivatives to hedge cash exposures, and mitigate economic risks and the potential for disputes that could disrupt the efficient operation of these vital markets at the time of a LIBOR discontinuance.

Timing of a NY Legislative Solution

The proposed legislation in the state of NY could go through myriad procedures before being passed, including floor debates, amendments, and consideration by committees in either the Senate, the Assembly, or both. However, there is no requirement that a bill must go through any of these procedures before becoming law. Regardless of the legislative procedures that are applied to a bill, in order for any proposed legislation to be passed, it must be introduced, voted on and passed by a majority of both the Senate and the Assembly, and then signed by the Governor.

The ARRC's proposed legislative solution to LIBOR discontinuation was intended to be passed in April 2020 along with the budget for fiscal year 2021. However, that did not occur due to the government's focus on coronavirus pandemic-related measures. Since the ARRC proposal was not passed with the Fiscal Year 2021 budget, and was not passed by the end of the legislative session in June 2020, it would take a special session for the NY Legislature to pass the proposal before the next legislative session begins in January 2021. Although a special session is possible, and in fact was called this year to deal with the coronavirus pandemic, it is not likely that the ARRC proposal will be passed before the next session begins in January 2021.

Once the January 2021 legislative session begins, the ARRC proposal can be passed at any time, which will require introduction of the bill in the Legislature, a vote and approval of the bill by both the Senate and the Assembly, and then a

[59] *See* pg. 10 of the ARRC's Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf.

signature by Governor Cuomo signing the bill into law. After a bill is sent to the Governor's desk, he has ten days to either sign or veto the bill. No action by the Governor in those ten days results in the bill becoming law. If a bill is vetoed by the Governor, the Legislature can override the veto with a two-thirds approval in both houses.

If approved, it is possible that the NY solution will not be effective before the discontinuation of LIBOR which raises a number of challenges and complexities that market participants will need to consider. Market participants should also bear in mind that the NY legislative solution only applies to NY governed contracts. While derivatives contracts are often governed by NY or English law, there is a host of other contract types that reference LIBOR and have different governing laws. The NY solution would not help these types of contracts absent a federal legislative solution.

3.5 Challenges

The interaction of the various U.S., UK, and EU tough legacy solutions are complex and may give rise to certain challenges for market participants, including those that relate to the following:

- **Timing** – the FCA has publicly stated that it may announce non-representativeness or future cessation in late 2020 or early 2021. There may be significant challenges for market participants if the solutions are not effective or at least settled by this time;
- **Conflicts of Laws** – there is a risk of conflicts of laws to the extent that two or more solutions impact a single contract;
- **Basis Risk** – basis risk within structures or between products if certain products are impacted by a solution and others are not, or products transition to a different rate under the various tough legacy solution;
- **Scoping and diligence** – scoping and diligence becomes difficult for market participants, as in certain instances (e.g. the current EU proposal) the extent of the relevant solution is not straightforward to assess;
- **Contracts without a legislative solution** – certain governing laws may not ever have a legislative solution (e.g. in the absence of a U.S. federal solution, certain non-NY state law-governed contracts would not have a "tough legacy" solution even if the NY legislative solution is implemented);
- **Litigation risk** – there is a risk of litigation if the UK synthetic LIBOR solution is imposed on counterparties who are not party to an English law contract and/or have no nexus to the UK, which risk may be heightened, particularly if other terms of the contract are inconstant with the synthetic LIBOR rate;
- **Brexit** – the impact of Brexit and on-shoring of any EU BMR solution may lead to the UK regulatory landscape in this context being particularly complex and uncertain.

While well intentioned and having the potential to be very helpful to transition, tough legacy solutions provided by policy makers and regulators alike can cause a number of complexities. The philosophical approach between different forms of relief is not the same and conflicts need to be considered. For illustrative purposes, it is possible that a single transaction could be subject to more than one form of tough legacy legislative "relief" in the event the proposed solutions by the EU, UK and U.S. are ultimately passed (e.g. a NY law-governed USD LIBOR contract with an EU counterparty (e.g. EU supervised entity) could be subject to (i) NY legislation because the contract is governed by NY law; (ii) UK legislation because it is linked to USD LIBOR; and (ii) EU legislation because it is entered into with an EU counterparty.) Accordingly, it is imperative that market participants continue to consider the scope, timing and uncertainty with respect to any proposed relief and legislative solutions and that regulators and legislators coordinate their efforts where possible.

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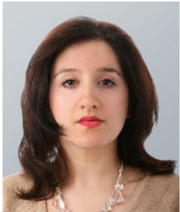

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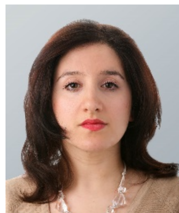

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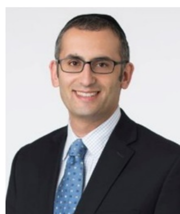

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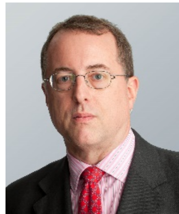

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