

HAWKINS ADVISORY

FEDERAL LEGISLATION MOVES SOFR CLOSER

On March 15, 2022, long-awaited federal legislation addressing the phase-out of United States market reliance upon the London Interbank Offered Rate (“LIBOR”)¹ as a reference rate was signed into law. With less than 16 months remaining before the expected end of USD LIBOR publication on June 30, 2023,² the *Adjustable Interest Rate (LIBOR) Act*³ (the “Federal LIBOR Act”) provides important context to inform market participants’ considerations of their current USD LIBOR variable-rate exposures and of potential active and passive approaches for transitioning to other reference rates. While not requiring use of the Secured Overnight Financing Rate published by the New York Fed (“SOFR”),⁴ as a successor benchmark to LIBOR, the law significantly increases federal pressure to assure market acceptance of SOFR.

The Federal LIBOR Act identifies a category of contracts that both: (i) set variable rates based on LIBOR; and (ii) do not include a fallback mechanism for selecting a different reference rate that can operate without reliance upon LIBOR, or upon a process of polling or other inquiry of banks as to their interbank lending or deposit rates.⁵ These contracts, which did not contemplate that contemporaneous LIBOR rates might become permanently unavailable, are sometimes referred to as “tough legacy contracts” and may include a wide range of variable-rate capital market transactions, commercial loans, consumer loans and equity instruments. They also include LIBOR-based derivative contracts where one or both parties have not adhered to a 2020 ISDA Protocol that was intended to avoid the need for specific amendments.⁶ However, they

¹ LIBOR rates may be set in various currencies and regulatory efforts in different jurisdictions to effect a phase-out of market reliance upon LIBOR and substitution of reference rates that are dependent upon observed market rates, rather than reported bank offered rates, have been separately undertaken by the applicable financial regulators and have proceeded on different timelines. In the United States, the Board of Governors of the Federal Reserve Bank (the “Federal Reserve”) and the Federal Reserve Bank of New York (the “New York Fed”) have been the lead regulators and have relied upon the International Swaps and Derivatives Association (“ISDA”) and the Alternative Reference Rate Committee (the “ARRC”), an advisory group of market participants convened by the Federal Reserve and the New York Fed, to develop, document and promulgate market-consensus standards and procedures to implement this transition. Much of the work that has been completed by the ARRC and ISDA is discussed in ARRA’s Progress Report. See Alternative Rates Reference Committee, Progress Report: The Transition from U.S. Dollar LIBOR (Mar 31, 2021), available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/USD-LIBOR-transition-progress-report-mar-21.pdf>. This Advisory addresses only contracts subject to United States law that set rates on the basis of United States dollar denominated LIBOR (“USD LIBOR”).

² Rates for overnight, one-month, three-month, six-month and twelve-month tenors of USD LIBOR are currently set and published by ICE Benchmark Administration Limited (“IBA”), a subsidiary of Intercontinental Exchange Inc. (“ICE”), based on information received by IBA from panel banks. On March 5, 2021, ICE announced that IBA intended to cease setting these rates immediately after the June 30, 2023 publication because a number of panel banks had advised IBA that they would not continue their participation after that date. See Intercontinental Exchange, Inc., ICE Benchmark Administration Publishes Feedback Statement for the Consultation on Its Intention to Cease the Publication of LIBOR® Settings (Mar 5, 2021) available at <https://ir.theice.com/press/news-details/2021/ICE-Benchmark-Administration-Publishes-Feedback-Statement-for-the-Consultation-on-Its-Intention-to-Cease-the-Publication-of-LIBOR-Settings/default.aspx>. This rate-setting process is overseen by the United Kingdom Financial Conduct Authority (the “UK” and the “FCA”), which immediately confirmed that the FCA did not expect to act to cause IBA or panel banks to continue their participation in USD LIBOR rate-setting after June 30, 2023 and that, even if synthetic setting of USD LIBOR for certain tenors were to continue beyond such date, the resulting reference rates would not be deemed representative of underlying market conditions for purposes of the UK Benchmark Regulation. See Financial Conduct Authority, Announcements on the End of LIBOR (Mar. 5, 2021), available at <https://www.fca.org.uk/news/press-releases/announcements-end-libor>. ISDA thereupon immediately confirmed that the FCA’s announcement constituted an “index cessation event” under the ISDA 2020 Fallbacks Protocol with respect to all USD LIBOR tenors, with the result that certain LIBOR to SOFR spread adjustments for the overnight, one-month, three-month, six-month and twelve-month tenors of USD LIBOR were determined as of March 5, 2021 for purposes of ISDA derivative contract substitution under the 2020 IBOR Fallbacks Protocol, which is now expected to take effect on June 30, 2023. See International Swaps and Derivatives Association, Inc., Future Cessation and Non-Representativeness Guidance (Mar 5, 2021 (updated Mar 8, 2021 and Apr 16, 2021)), available at <https://www.isda.org/a/dIFTE/ISDA-Guidance-on-FCA-announcement-LIBOR-Future-Cessation-and-Non-Representativeness-April-Update.pdf>. On March 8, 2021, ARRC confirmed that the FCA’s announcement would also trigger reference rate substitutions under ARRC-recommended fallback provisions. See Alternative Reference Rate Committee, ARRC Confirms a “Benchmark Transition Event” has occurred under ARRC Fallback Language (Mar 8, 2021), available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC-Benchmark-Transition-Event-Statement.pdf>. See footnotes 4, 6 and 9.

³ The Adjustable Interest Rate (LIBOR) Act, Pub. L. No. 117-103 (2022) was enacted as Division U of the Consolidated Appropriations Act, 2022, available at <https://www.congress.gov/117/bills/hr2471/BILLS-117hr2471enr.pdf> (pp. 777-786).

⁴ Generally, SOFR is determined and published by the New York Fed on each business day based on reported rates on overnight repurchase agreements secured by United States Treasury securities. See Alternative Rates Reference Committee, Transition from LIBOR, available at <https://www.newyorkfed.org/arrc/sofr-transition#aboutsofr> (last visited Mar 21, 2022).

⁵ Adjustable Interest Rate (LIBOR) Act, Pub. L. No. 117-103 § 104(a). (2022).

⁶ ISDA opened its 2020 IBOR Fallbacks Protocol (the “ISDA 2020 Fallbacks Protocol”) for adherence by parties to derivative contracts on October 23, 2020. The ISDA 2020 Fallbacks Protocol provides for the incorporation of ISDA recommended benchmark rate fallback provisions into eligible USD LIBOR denominated derivative contracts between parties that have both adhered to its provisions. Such provisions include the specification of certain index cessation events, the occurrence of which would trigger substitution of a new benchmark replacement rate for the affected USD LIBOR rate, as specified in the ISDA 2020 Fallbacks Protocol, without the need for an express specific amendment of the derivative contract and without regard to the express provisions thereof. Under the ISDA 2020 Fallbacks Protocol, the March 5, 2021 index cessation events described in footnote 2 are expected to result in automatic reference rate substitution for derivative contracts to which it applies, which is expected to be effective as of the completion of June 30, 2023 rate-setting. See International Swaps and Derivatives Association, Inc., 2020 IBOR Fallbacks Protocol, available at <https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/> (last visited Mar 21, 2022).

do not include contracts where one party is contractually entitled to choose a successor reference rate unilaterally or contracts that have been amended to provide for a new reference rate or an adequate fallback mechanism.⁷

The Federal LIBOR Act includes “by operation of law” provisions⁸ that are limited to such “tough legacy contracts”. These provisions reform these contracts to substitute a benchmark identified by the Federal Reserve that is based on SOFR, including specified tenor spread adjustments,⁹ as of: (i) the first London banking day subsequent to June 30, 2023; or (ii) with respect to any tenor of LIBOR, another date upon which the Federal Reserve determines that such LIBOR tenor will cease to be published or to be representative (a “LIBOR Replacement Date”).¹⁰ This permits the Federal Reserve to advance or delay the LIBOR Replacement Date applicable to one or more tenors of LIBOR in response to developments.¹¹ In addition to putting into place eventual backstop treatment should the parties to a “tough legacy contract” not themselves address the issue of LIBOR termination, this provision attempts avoid the otherwise possible conversion of a variable-rate contract into a fixed-rate contract.¹²

The Federal LIBOR Act also includes more generally applicable provisions limiting legal recourse available to a party objecting to the substitution of SOFR for LIBOR.¹³ Other provisions of the Federal LIBOR Act establish a process for substitution of SOFR for LIBOR in calculating special allowance payments between the federal Department of Education and holders of Federal Family Education Loan Program portfolios¹⁴ and provide for a one-year period (beginning on the LIBOR Replacement Date) that relates only to consumer loans, during which the applicable Federal Reserve-approved tenor spread adjustment between LIBOR and SOFR is to be phased in

“linearly” as “adjusted” by the Federal Reserve.¹⁵ Additional provisions confirm that a complying SOFR substitution is not prohibited under the federal Trust Indenture Act¹⁶ and address federal bank regulatory¹⁷ and consumer lending law¹⁸ treatment.

The Federal LIBOR Act mandates the Federal Reserve to promulgate regulations to carry out its provisions within 180 days of enactment.¹⁹ Depending upon the scope and complexity of the implementing regulations that the Federal Reserve might propose, their adoption may not be completed much before the LIBOR Replacement Date.²⁰ The Federal Reserve’s normal regulatory process requires approval by its Board of both proposed and final regulations and an intervening public comment period.²¹ Taking into account the requirement that its regulations cannot become effective until 30 days after Federal Register publication, it seems likely that this process may require at least one-third of the time remaining before June 30, 2023, leaving relatively little time for market participants to adjust to any regulations adopted. While this might suggest that a minimalist approach to such regulation would be prudent, especially given the amount of work that has already been done by the New York Fed, ISDA and the ARRC to prepare for the introduction of SOFR, it is uncertain how extensive implementing regulations may be. One possible topic that would seem likely to have monetary effect might be an update, or method for updating, the tenor spread adjustments to reflect the passage of time and any changes in relative LIBOR and SOFR rates between March 5, 2021 and the LIBOR Replacement Date.²² Another that might have operational consequences and affect the temporary basis risk that the Federal LIBOR Act creates for lenders who finance their portfolios might be further specification of the

⁷ As an example, adherence by all parties to a derivative contract to the ISDA 2020 Fallbacks Protocol described in footnote 6 may be viewed as such an amendment.

⁸ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103 § 104. (2022).

⁹ The Federal LIBOR Act incorporates the tenor spread adjustments described in footnote 2, which were determined on the basis of historical data that was available on March 5, 2021. Accordingly, these do not reflect any changes in the relationship between LIBOR and any tenor of SOFR between that date and a “by operation of law”, or earlier voluntary, conversion to SOFR. This may result in the tenor spread adjustments becoming less reliable measures of the relationship between reference rates at the time of conversion and, for portfolio financings where conversion occurs separately for assets and liabilities, in potential basis risk.

¹⁰ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, §103(17). (2022).

¹¹ The impact of a change in LIBOR Replacement Date upon the expected schedule for Federal Reserve adoption of implementing regulations and for market participants’ operational preparations might be substantial. See text at footnotes 19-23.

¹² Many capital markets contracts that did not contemplate a permanent cessation of LIBOR setting or publication expressly provide that, if a new rate could not be established on the basis of a more recently published LIBOR rate or, in many instances, through bank-polling, the last established LIBOR-based rate would remain in effect. While not an unreasonable provision in the context of a temporary interruption to LIBOR-based rate setting, it’s long-term or permanent operation would result in an effective fixed rate. This unintended result may confer an opportunistic benefit upon one party or the other as market variable rates continue to fluctuate. The problem is compounded for portfolio financings, where disparate treatment of rates applicable to assets and liabilities may create basis risk.

¹³ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, §105. (2022). Issues might relate to the existence of trigger events or rate-setting mechanics. See footnote 12.

¹⁴ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, § 109. (2022). Hawkins Delafield & Wood LLP assisted the Education Finance Council in developing this provision.

¹⁵ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, §104(e)(2). (2022).

¹⁶ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, §108. (2022).

¹⁷ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, §106. (2022).

¹⁸ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, §104(f). (2022).

¹⁹ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, § 110. (2022).

²⁰ See text at footnotes 9-11.

²¹ See Board of Governors of the Federal Reserve System, What specific steps does the Board take to issue a regulation?, available at <https://www.federalreserve.gov/faqs/steps-board-takes-to-issue-a-regulation.htm> (last visited Mar 22, 2022).

²² See footnotes 9 and 11.

precise method of phasing in tenor spread adjustments applicable to consumer loans.²³

The Federal LIBOR Act states that its provisions and implementing regulations shall supersede “any provision of any State or local law, statute, rule, regulation, or standard relating to the selection or use” of a benchmark to replace LIBOR or “expressly limiting the manner of calculating interest” for a Federal Reserve-approved SOFR-based benchmark.²⁴ It seems possible that State law provisions directed at discouraging litigation over voluntary benchmark substitution that are broader in effect than the federal language could remain effective.

Although each of the House and the Senate considered provisions that would have expressly addressed the federal tax treatment of reference rate substitution to eliminate LIBOR dependence, or authorized the Treasury to adopt regulations to do so, no such provision was included in the Federal LIBOR Act. Accordingly, the current Internal Revenue Service and Treasury guidance under Rev. Proc. 2020-44²⁵ and under the Final Regulations released on

January 4, 2022²⁶ remain applicable. The Final Regulations became fully effective on March 7, 2022.

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²³ See text at footnote 15.

²⁴ Adjustable Interest Rate (LIBOR) Act, Pub. L. No.117-103, §107 (2022).

²⁵ Rev. Proc. 2020-43, 2020-45 I.R.B. 991 (I.R.S. October 16, 2020) (discussed, [Some Guidance Relating to Transitions Away from LIBOR | Hawkins Delafield & Wood LLP](#)).

²⁶ TD 9961, 87 FR 166 (discussed, [Guidance from Treasury regarding USD LIBOR Phase-Out | Hawkins Delafield & Wood LLP](#) and [Final Treasury Reissuance Regulations Addressing Modifications of Debt Instruments to Replace IBORs | Hawkins Delafield & Wood LLP](#))

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