

U.S. Federal Reserve Issues Final Rule Under Federal LIBOR Act

December 19, 2022

Introduction

The Board of Governors of the Federal Reserve System (the “Board”) has issued a [final rule](#) (the “Rule”) relating to LIBOR transition. The Rule was promulgated under the [Adjustable Interest Rate \(LIBOR\) Act](#) (the “Act”), which was signed into federal law earlier this year.

The Rule was approved by the Board on December 16, 2022 and will become effective 30 days after it is published in the Federal Register. However, for most purposes relating to the Rule, the most significant date is the first London banking day after June 30, 2023, which is the “LIBOR replacement date” referred to in the Act and the Rule.¹ On that date, the “benchmark replacements” that are a principal subject of the Rule will become effective.

We describe the benchmark replacements below, along with a few other aspects of the Rule and some considerations relating to synthetic LIBOR and implementation by contracting parties.

The Act and the Rule apply only to contracts governed by U.S. law (including the law of any U.S. state) that use U.S. dollar LIBOR of overnight, one-month, three-month, six-month, and 12-month tenors; and we use “LIBOR” and “LIBOR contract” accordingly.

Benchmark Replacements

As contemplated by the Act, the Rule establishes benchmark replacements for certain LIBOR contracts with a benchmark replacement problem. A contract has a problem if, by its terms, (i) its rate continues to be based on assumed floating values of LIBOR (by

¹ Under the Act and the Rule, the definition contemplates that the Board can determine that any LIBOR tenor will cease to be published or cease to be representative on a different date, in which case presumably the defined term will be construed accordingly. We are not aware of any plan of the Board to make such a determination.

Certain terms used herein are used as defined in the Act or the Rule. Each of the Act and Rule defines certain terms in lower case.

reference to published rates or polling), instead of an alternative such as the prime rate (whether the alternative is baked in or chosen by a transaction participant), or (ii) its rate may be expressed in terms of the last known value of LIBOR (a “frozen LIBOR” provision). In any such case, the Act is based on the theory that the contract will no longer make economic sense because the benchmark replacement either won’t work or will result in a “fixed” LIBOR that was not intended when the contract was entered into.

Section 253.4 of the Rule provides benchmark replacements for contracts governed by U.S. law that reference the overnight and one-, three-, six-, and 12-month tenors of LIBOR, as follows, subject to various details omitted here and also subject to the tenor spread adjustments described below:

- Derivative transactions:² The benchmark replacement will be the one identified as the “Fallback Rate (SOFR)” in the ISDA protocol for each day on which LIBOR would ordinarily be observed occurring on or after the LIBOR replacement date. The Fallback Rate (SOFR) is a rate published by Bloomberg Professional Services. It is calculated based on SOFR compounded in arrears over an accrual period corresponding to the tenor of the LIBOR rate specified in the relevant derivatives transaction. The Fallback Rate (SOFR), as published by Bloomberg, includes a spread adjustment for the relevant tenor equal to the tenor spread adjustments specified in the Act and the Rule and described below.
- Contracts that are not consumer loans,³ FHFA⁴-regulated-entity contracts, or FFELP ABS:⁵
 - In place of overnight LIBOR: “SOFR,” which is the Secured Overnight Financing Rate published by the Federal Reserve Bank of New York.
 - In place of one-, three-, six-, or 12-month tenors of LIBOR: The corresponding one-, three-, six-, or 12-month “CME Term SOFR,” which is

² The Rule defines a “derivative transaction” as “a contract that would satisfy the criteria to be a ‘Protocol Covered Document’ under the ISDA protocol but for the fact that one or more parties to such contract is not an ‘Adhering Party’ as such term is used in the ISDA protocol, provided that, for purposes of this definition, ‘Protocol Effective Date’ as such term is used in the ISDA protocol means the LIBOR replacement date for the relevant LIBOR contract.” The Rule defines the “ISDA protocol” as “the ISDA 2020 IBOR Fallbacks Protocol published by the International Swaps and Derivatives Association, Inc., on October 23, 2020, and minor or technical amendments thereto.”

³ The Rule defines a “consumer loan” as “a consumer credit transaction” and provides that “consumer” has the same meaning as in Section 103 of the federal Truth in Lending Act. While FHFA-regulated-entity contracts or FFELP ABS may meet this definition, the Rule treats them separately.

⁴ I.e., the Federal Housing Finance Agency.

⁵ The Rule defines “FFELP ABS” as asset-backed securities for which more than 50% of the collateral pool consists of Federal Family Education Loan Program loans, as reported in the most recent servicer report available on the LIBOR replacement date.

the CME Term SOFR Reference Rate as administered by CME Group Benchmark Administration, Ltd.

- Consumer loans:
 - In place of overnight LIBOR: SOFR, subject to a transition provision for the one-year period beginning on the LIBOR replacement date.
 - In place of one-, three-, six-, or 12-month tenors of LIBOR: The corresponding one-, three-, six-, or 12-month CME Term SOFR, subject to a transition provision for the one-year period beginning on the LIBOR replacement date.
- FHFA-regulated-entity contracts that are not Federal Home Loan Bank advances:
 - In place of overnight LIBOR: SOFR.
 - In place of one-, three-, six-, or 12-month tenors of LIBOR: “30-day Average SOFR,” which is a 30-calendar-day compounded average of SOFR, as published by the Federal Reserve Bank of New York.
- FHFA-regulated-entity contracts that are Federal Home Loan Bank advances: The “Fallback Rate (SOFR)” in the ISDA protocol for each day on which LIBOR would ordinarily be observed occurring on or after the LIBOR replacement date.⁶
- FFELP ABS:
 - In place of one-month LIBOR: 30-day Average SOFR.
 - In place of three-month LIBOR: “90-day Average SOFR,” which is a 90-calendar-day compounded average of SOFR, as published by the Federal Reserve Bank of New York.
 - In place of six- or 12-month tenors of LIBOR: 30-day Average SOFR.

With the exception of the benchmark replacements based on 30-day Average SOFR and 90-day Average SOFR, these benchmark replacements are overnight rates or term rates.

⁶ The Rule provides “[f]or clarity” that the reference to “spread relating to U.S. dollar LIBOR” in the definition of “Fallback Rate (SOFR)” in the ISDA protocol is equal to the applicable tenor spread adjustment described below.

Basis Risk

The Rule adopts different benchmark replacements for derivatives transactions versus cash market transactions. Accordingly, after the LIBOR replacement date, there will be basis risk for transactions that (i) include both a cash market transaction (such as the rate on the transaction's liabilities) and a derivative transaction (to hedge or offset the related cash market transaction) and (ii) rely on the Rule to address the LIBOR transition. This basis risk could have an adverse impact on the cash flows of transactions, including structured finance transactions that have defined and limited sources and uses of cash flows. Noting the potential for basis risk and several comments regarding it, the Board nonetheless opted in the Rule for a more "simple, clear and manageable" approach to the Rule with a single benchmark replacement for each derivatives transaction, even if it is intended to hedge cash market transaction that will fall back to a different benchmark replacement under the Rule.⁷

Tenor Spread Adjustments and Resulting Rates

The tenor spread adjustments are spreads that are added to the benchmark replacements to result in the new post-LIBOR rate. The Rule repeats them verbatim from the Act, and they are as follows:

- 0.00644% for overnight LIBOR;
- 0.11448% for one-month LIBOR;
- 0.26161% for three-month LIBOR;
- 0.42826% for six-month LIBOR; and
- 0.71513% for 12-month LIBOR.

Thus, for example, suppose you have a contract subject to the Act and the Rule that is not a consumer loan, an FHFA-regulated-entity contract, or a FFELP ABS. Suppose its contract rate is three-month LIBOR plus 1%. As a result of the benchmark replacement and the tenor spread adjustment, the rate will become, on the LIBOR replacement date, three-month CME Term SOFR + 0.26161% + 1% = three-month CME Term SOFR + 1.26161%.

⁷ Discussing the possibility of adopting different benchmark fallbacks for different types of derivatives transactions, the Board stated: "The addition of new sub-categories of derivatives transactions would increase greatly the complexity of the rule and increase burden associated with determining the applicable Board-selected benchmark replacement for a given LIBOR contract." The Board stated that "nothing in the LIBOR Act or final rule prevents parties to LIBOR contracts from agreeing to transition a particular LIBOR contract to a benchmark replacement that is more suitable to that contract than the Board-selected benchmark replacement." Of course, there may be practical limitations on effecting any such agreement.

Benchmark Replacement Conforming Changes

The Act and the Rule contemplate the implementation of “benchmark replacement conforming changes” for contracts that transition to a benchmark replacement thereunder. The implementation of benchmark replacement conforming changes is subject to safe-harbor protections under the Act and the Rule, which permit implementation without the requirement to obtain consent from any other person (such as an investor). The Rule defines them as follows (without substantive variation from the Act in this respect):

Benchmark replacement conforming change means any technical, administrative, or operational change, alteration, or modification that (i) the Board determines, in its discretion, would address one or more issues affecting the implementation, administration, and calculation of the Board-selected benchmark replacement in LIBOR contracts; or (ii) solely with respect to a LIBOR contract that is not a consumer loan, in the reasonable judgment of a calculating person,⁸ are otherwise necessary or appropriate to permit the implementation, administration, and calculation of the Board-selected benchmark replacement under or with respect to a LIBOR contract after giving due consideration to any benchmark replacement conforming changes determined by the Board under item (i) of this definition.

Section 253.5 of the Rule provides for the following specific benchmark replacement conforming changes (which may be supplemented by further Board action):

- Any reference in a LIBOR contract subject to the Rule to a specified source for LIBOR (such as a particular newspaper, website, or screen) shall be replaced with the publication of the applicable Board-selected benchmark replacement (inclusive or exclusive of the relevant tenor spread adjustment described above) by either the relevant benchmark administrator for the applicable Board-selected benchmark replacement or any third party authorized by the relevant benchmark administrator to publish the applicable Board-selected benchmark replacement.
- Any reference to a particular time of day for determining LIBOR (such as 11:00 a.m. London time) shall be replaced with the standard publication time for the applicable Board-selected benchmark replacement (inclusive or exclusive of the relevant tenor spread adjustment described above), as established by the relevant benchmark administrator.
- Any provision of a LIBOR contract requiring use of a combination (such as an average) of LIBOR values over a period of time that spans the LIBOR

⁸ Defined in the Rule, as in the Act, as “with respect to any LIBOR contract, any person, including the determining person, responsible for calculating or determining any valuation, payment, or other measurement based on a benchmark.”

replacement date shall be modified to provide that the combination shall be calculated consistent with that contractual provision using (i) the applicable LIBOR for any date prior to the LIBOR replacement date and (ii) the applicable Board-selected benchmark replacement rate for any date on or following the LIBOR replacement date, respectively.

- Subject to certain exceptions, if a Board-selected benchmark replacement is not available or published on a particular day indicated in the LIBOR contract as the determination date, the most recently available publication of the Board-selected benchmark replacement will apply.

Determining Persons

The Act and the Rule refer to “determining persons” as having certain roles with respect to LIBOR contracts and LIBOR transition. The Rule adds the underlined material to the Act’s definition of “determining person”: “with respect to any LIBOR contract, any person with the sole authority, right, or obligation, including on a temporary basis (as identified by the LIBOR contract or by the governing law of the LIBOR contract, as appropriate) to determine a benchmark replacement, whether or not the person’s authority, right, or obligation is subject to any contingencies specified in the LIBOR contract or by the governing law of the LIBOR contract.” The material at the end makes clear that the ability to determine may be contingent.

The Rule addresses the possibility that a determining person might not make determinations that it is permitted or required to make, and the Rule makes the related contract subject to the Act and the Rule as if there were no determining person:

- Section 104 of the Act scopes in LIBOR contracts that either (i) contain no fallback provisions (which are terms for determining a benchmark replacement) or (ii) contain fallback provisions that identify neither a specified benchmark replacement (such as a fallback to a prime rate) nor a determining person (which could designate a replacement).
- Section 253.3 of the Rule also scopes in contracts that have fallback provisions that identify a determining person but as to which the determining person does not make a timely selection of a benchmark replacement. For example, if a contract permits the determining person to select a prime rate as the replacement but it does not do so on a timely basis, the mandatory benchmark replacement would apply pursuant to the Act and the Rule as it would if the contract had no determining person.

What About Synthetic LIBOR?

There has been some market uncertainty about the impact of the availability of “synthetic LIBOR” for certain contracts on the transition from LIBOR. As the Board explains on pages 4-5 of the “Supplementary Information” section of the Rule (footnotes omitted):

To allow most legacy USD LIBOR contracts governed by non-U.S. law to mature without disruption, the FCA [i.e., the U.K.'s Financial Conduct Authority] also announced that the panels for the remaining five tenors of USD LIBOR would continue through, but cease after, June 30, 2023. The FCA has proposed to require IBA [i.e., ICE Benchmark Administration Limited, which is the current administrator of LIBOR] to continue publishing one-, three-, or six-month USD LIBOR on a synthetic basis until the end of September 2024 (synthetic LIBOR). As with synthetic GBP or JPY LIBOR settings, the FCA has announced that synthetic LIBOR settings are “not representative of the markets that the original LIBOR settings were intended to measure.”

Without further clarification, and perhaps final action, by the FCA and IBA, there is uncertainty as to whether synthetic LIBOR will be published and, if so, as to what its characteristics will be. However, based on announcements relating to the FCA's consultation on the topic⁹ and the “Supplementary Information” section of the Rule, we believe there is a general sense as follows:

- Synthetic LIBOR will be non-representative (i.e., non-representative of particular transactions to which the original LIBOR concept applies).
- Synthetic LIBOR will be calculated as CME Term SOFR plus the relevant ISDA fixed spread adjustment. The resulting rate will equal the Board-selected benchmark rate (including the relevant tenor spread adjustment) from the Act as described above.
- It will be available for all legacy contracts other than cleared derivatives.

Some market participants, including commenters on the Rule as initially proposed, have questioned the need for synthetic LIBOR in U.S. markets, which benefit from the Act and the Rule, unlike other markets. An FCA announcement in November 2022 suggests that synthetic LIBOR may be designed to plug a narrow gap in transition coverage that remains in certain non-U.S. law contracts:

Many US dollar LIBOR contracts have provisions which trigger their conversion to alternative rates (e.g. risk-free rates) when publication on a representative basis ends after 30 June 2023. Others, particularly many contracts under US law, are covered by legislative provisions that will enable their conversion to appropriate alternative rates at this point. But respondents to our consultation highlighted a significant number of contracts in cash markets, in particular cash markets outside the United

⁹ *Further consultation and announcements on the wind-down of LIBOR*, FIN. CONDUCT AUTH. (Nov. 23, 2022), <https://www.fca.org.uk/news/news-stories/further-consultation-announcements-wind-down-libor>.

States, that would benefit from a period of publication of US dollar LIBOR on a synthetic basis.¹⁰

However, the Board's discussion implies that synthetic LIBOR could be relevant for certain U.S. law contracts that are outside the scope of the Act. The Rule does not address synthetic LIBOR or how the Act might apply differently to contracts governed by U.S. law if synthetic LIBOR is available. A number of commenters on the Board's initial proposed rule sought clarity on these topics. The Board's "Supplementary Information" section offers two primary takeaways in this regard:

- There had been inquiries about whether synthetic LIBOR would affect fallback provisions in legacy contracts that are triggered if LIBOR is "unavailable" but not triggered if LIBOR is merely no longer "representative" of the market it is intended to measure. Not surprisingly, the Board declined to read non-representativeness triggers into legacy fallback provisions, reasoning that any "LIBOR contracts containing fallback provisions that identify a specific benchmark replacement are outside the scope of the [Act], even if these fallback provisions lack an express non-representativeness trigger." Accordingly, as is always the case, any legacy contract with an adequate fallback provision will need to be interpreted under applicable contract law to determine whether a contract will first fall back to (or continue with) synthetic LIBOR as its "LIBOR" for its anticipated duration through the end of September 2024 rather than another contractually prescribed fallback rate (such as a prime rate). Parties will need to examine their definition of LIBOR and other relevant provisions to determine the outcome, and they will need to consider any potential issues that may arise as a result of indirect importation of SOFR-based rates into a LIBOR-based contract without the facilitating features and protections of the Act.
- The Board responded less clearly to requests for clarification about "how synthetic LIBOR would affect a LIBOR contract that includes fallback provisions authorizing a [determining] person to select a benchmark replacement only when LIBOR is unavailable." The Board states that if a legacy contract identifies a determining person (including one with contingent authority) and the determining person does not select a benchmark replacement by the LIBOR replacement date, the applicable Board-selected benchmark replacement will be the benchmark replacement for the LIBOR contract under Section 104(c)(3) of the Act, presumably, if not explicitly, even if synthetic LIBOR is available at that time.

¹⁰ *Id.*

The Board's fullest discussion of synthetic LIBOR is on pages 26-29 of the "Supplementary Information" section of the Rule (footnotes omitted):

Synthetic LIBOR. When issuing the proposal, the Board sought feedback on whether the final rule should clarify how the LIBOR Act [i.e., the "Act" as defined herein] would apply if the FCA requires IBA (or any successor administrator) to publish synthetic LIBOR on and after the LIBOR replacement date.

The Board specifically requested comment on how synthetic LIBOR might affect LIBOR contracts that contain fallback provisions that either identify a clear and practicable benchmark replacement or authorize a person to select a benchmark replacement, but where these fallback provisions are triggered only where LIBOR is unavailable (and are not expressly triggered where a benchmark called "LIBOR" is available but is not representative of the market that LIBOR is intended to measure). For example, the Board requested comment on whether the final rule should provide that a LIBOR contract containing fallback provisions that identify a clear and practicable benchmark replacement (e.g., the prime rate) but lack an express non-representativeness trigger would transition to the benchmark replacement specified in the LIBOR contract (i.e., the prime rate) on the earlier of (i) the date specified pursuant to the LIBOR contract or (ii) the LIBOR replacement date.

Several commenters supported the clarification outlined in the proposal. In general, these commenters argued that such clarification would (i) be consistent with the intent of the statute, (ii) promote an orderly transition away from LIBOR, (iii) reduce disruptive litigation, and (iv) be reasonable.

However, some commenters argued that the Board lacks the legal authority to adopt the clarification outlined in the proposal. In particular, these commenters noted that LIBOR contracts containing fallback provisions that identify a specific benchmark replacement (e.g., the prime rate) are outside the scope of the LIBOR Act, even if they lack an express non-representativeness trigger. Accordingly, these commenters recommended that the Board clarify only the ambiguity described in the proposal with respect to LIBOR contracts that authorize a determining person to select a benchmark replacement when LIBOR is unavailable[.]

Other commenters gave other suggestions for addressing synthetic LIBOR. For example, one commenter asked the Board to work with the FCA to avoid the publication of synthetic LIBOR altogether. Other commenters suggested that the Board should deem LIBOR to be unavailable for all LIBOR contracts within the scope of the LIBOR Act even if synthetic LIBOR would be published, unless a determining person affirmatively selects synthetic LIBOR as a benchmark replacement; these

commenters argued that construing synthetic LIBOR's publication as continued availability of LIBOR would be inconsistent with the purposes of the LIBOR Act.

The Board has considered this issue in light of the comments received. The Board believes that LIBOR contracts containing fallback provisions that identify a specific benchmark replacement are outside the scope of the LIBOR Act, even if these fallback provisions lack an express non-representativeness trigger. In particular, section 102(b)(3) of the LIBOR Act states that one purpose of the statute is to allow existing contracts that reference LIBOR but provide for the use of a clearly defined and practicable replacement to operate according to their terms. Further, section 104(f)(2) of the LIBOR Act expressly provides that nothing in the statute may be construed to alter or impair any LIBOR contract that contains fallback provisions that identify a benchmark replacement and are not LIBOR- or poll-based fallback provisions. The Board believes these provisions of the statute unambiguously remove LIBOR contracts that identify a specific benchmark replacement (e.g., the prime rate) from the scope of the LIBOR Act, even if these fallback provisions lack an express non-representativeness trigger.

However, consistent with the suggestion of some commenters, the Board is clarifying in the final rule how synthetic LIBOR would affect a LIBOR contract that includes fallback provisions authorizing a person to select a benchmark replacement only when LIBOR is unavailable. As noted in section IV.B, the final rule defines a determining person to include a person with a contingent authority, right, or obligation to determine a benchmark replacement. Under the final rule, a person who has the authority, right, or obligation to select a benchmark replacement when LIBOR is unavailable is a "determining person;" accordingly, such person has a statutory right under section 104(c)(1) and (c)(2) of the LIBOR Act to select the Board-selected benchmark replacement by the earlier of (i) the LIBOR replacement date and (ii) the latest date for selecting a benchmark replacement according to the terms of the LIBOR contract. If the determining person does not select a benchmark replacement by the LIBOR replacement date, the applicable Board-selected benchmark replacement will be the benchmark replacement for the LIBOR contract under section 104(c)(3) of the LIBOR Act.

The market may have to wait for further developments in this area, and hopefully more clarity on the subject of synthetic LIBOR will develop over time so as to reduce the potential for disputes over how legacy contracts should operate.

How Will This All Be Implemented?

As June 30, 2023 approaches, market participants are considering formal implementation issues relating to their contracts that are within the Act's scope. This applies to both the basic rate replacements and conforming changes (both those in the Rule and those implemented separately).

For example, even if a contract will clearly transition from a LIBOR-based rate to a SOFR-based rate under the Act, the parties (and other beneficiaries like noteholders under an indenture) may want the certainty of a memorialization of the rate, and a public issuer may want a memorialization that can be filed with the SEC as part of the filed terms of a transaction or the issuer's capital structure accessible through EDGAR.

However, Section 105(d) of the Act provides that the selection or use of a Board-selected benchmark replacement or the determination, implementation, or performance of benchmark replacement conforming changes under Section 104 "shall not be deemed to be an amendment or modification of any LIBOR contract." Accordingly, the form of any memorialization in many cases will not be an amendment but rather a statement or notice of some kind, depending on the circumstances. There will also be an interplay between this stage of memorialization and any heads-up notice given to parties as June 30, 2023 approaches.

This is a developing area, and different contracts may require different approaches.

Contacts:

If you have any questions regarding this Sidley Update, please contact one of the Sidley lawyers with whom you usually work, or

T.J. Gordon, Partner	+1 312 853 7375	tgordon@sidley.com
Istvan A. Hajdu, Counsel	+1 212 839 5651	ihajdu@sidley.com
Ellen P. Pesch, Partner	+1 617 223 0330	epesch@sidley.com
Myles C. Pollin, Partner	+1 212 839 5307	mpollin@sidley.com
Allison J. Satyr, Partner	+1 312 853 4342	asatyr@sidley.com
David K. Solow, Partner	+1 312 853 3103	dsolow@sidley.com

Sidley Austin LLP provides this information as a service to clients and other friends for educational purposes only. It should not be construed or relied on as legal advice or to create a lawyer-client relationship. Readers should not act upon this information without seeking advice from professional advisers.

Attorney Advertising—Sidley Austin LLP, One South Dearborn, Chicago, IL 60603. +1 312 853 7000. Sidley and Austin refer to Sidley Austin LLP and affiliated partnerships, as explained at www.sidley.com/disclaimer.

© Sidley Austin LLP