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Interest Rates Watch: ARRC Releases Recommended Best Practices and Conventions for Use of SOFR Term Rates in Contracts

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Welcome back to our *Interest Rates Watch* series, developed to provide timely updates and practical advice on developments related to interest rates and benchmarks on a regular basis. As always, we are here to help.

On July 21, 2021, the Alternative Reference Rates Committee (ARRC) released recommended best practices for use of forward-looking secured overnight financing rate (SOFR) term rates (SOFR Term Rates) in contracts, as well as recommended conventions for both SOFR Term Rates and SOFR averages. This comes in anticipation of the ARRC's formal recommendation of SOFR Term Rates, which is expected to occur shortly after July 26, 2021, when the first phase of SOFR First, an initiative for switching trading conventions from LIBOR to SOFR, is recommended to occur.

Although the use of SOFR Term Rates will not be appropriate in all circumstances,[1] the ARRC continues to support the use of SOFR Term Rates for business loans. In addition to SOFR Term Rates, parties in business loans may choose to use one of several other SOFR-based rates.[2]

The updated ARRC fallback language for contracts that reference USD LIBOR,[3] which has been widely adopted in syndicated loans, bilateral business loans and many other commercial contracts, provides for a fallback waterfall, with the first step in such waterfall being SOFR Term Rates. Following formal recommendation of SOFR Term Rates by the ARRC, legacy contracts that have adopted the ARRC's updated fallback language will, if the relevant SOFR Term Rate tenor exists, fall back to such SOFR Term Rate once the applicable LIBOR replacement date occurs.

In preparation for a switch to a SOFR-based rate, the ARRC has recommended certain loan conventions. Where USD LIBOR is replaced with SOFR Term Rates, many of the loan conventions are similar to LIBOR loan conventions, given that the interest rate is known in advance of the interest period. Such conventions include:

- **Rate Publication Calendar and "Business Day" conventions:** "Business Day" should be defined to align with the rate-publication calendar for SOFR and payments scheduled to be made on non-Business Days should be adjusted to the next-succeeding Business Day (or, if the next-succeeding

Business Day falls in the next calendar month, the immediately-preceding Business Day).

- **Temporary Unavailability of Rate:** Documentation should include a temporary fallback convention to address situations where the relevant SOFR-based rate (or relevant tenor thereof) is not published for a short period of time.
- **Lookback:** The applicable rate should be the rate published two business days prior to the first day of the applicable interest period and held for the entirety of the interest period.
- **Borrowing Notice Period**: It is recommended that borrowers submit a borrowing request three business days prior to the borrowing date, similar to LIBOR convention.
- **Day Counts**: The ARRC recommends the use of a day count convention of Actual/360 days for SOFR Term Rates and SOFR averages, consistent with the standard convention in US money markets.
- **Compensation for Losses**: Consider including language that compensates lenders for funding losses (e.g., break fees resulting from intra-period prepayment and losses resulting from the failure to make borrowings or payments when due or scheduled).
- **Interest Rate Floor**: Parties should consider including an interest rate floor, noting that an existing floor for USD LIBOR would continue to apply where the ARRC's updated fallback language has been adopted.
- **Rounding**: SOFR Term Rates and SOFR averages will be published to five decimal places, as with LIBOR; as such, parties may consider using their current rounding practices.
- **Fallback Language:** documentation should include robust fallback language.[3]

Recommendations

Given that there have been several iterations of the ARRC's fallback language (including an initial "amendment approach" which was adopted in many contracts early on in the LIBOR replacement process), parties should review documentation that references USD LIBOR to determine the extent of the fallback language included therein (if any) and whether any amendments are required and/or recommended.

- Contacts that do not contain fallback language should be amended to either (a) incorporate the ARRC's recommended "hardwired approach" fallback language or (b) replace USD LIBOR with a SOFR-based benchmark replacement.
- Where contracts contain the ARRC's "amendment approach" fallback language, parties should consider either (a) amending to incorporate the ARRC's recommended "hardwired approach" fallback language or (b) utilizing the amendment process set out therein to select a SOFR-based benchmark replacement.
- For contracts that contain a form of the ARRC's "hardwired approach" fallback language, parties should be aware that LIBOR will be automatically replaced with SOFR Term Rates, and such replacement will occur on the earlier of (a) the cessation of LIBOR, (b) LIBOR being declared to no longer be representative and (c) an early-opt in election by the relevant parties. Parties should also

be aware that the ability to make an early opt-in election drives off of the adoption of a SOFR-based rate in other comparable credit facilities.
- In all instances, parties should review existing documents to determine if the ARRC's recommended SOFR conventions should be included.

We will be issuing further articles relating to interest rates. Find other articles in our Interest Rates Watch Series here.

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[1] The ARRC does not support the use of SOFR Term Rates for the vast majority of derivatives markets, where an alternative SOFR-based rate should be utilized.

[2] Alternative SOFR-based rates include daily simple SOFR in arrears, daily compounded SOFR in arrears and SOFR averages, applied in advance (being compounded averages of SOFR over rolling 30-, 90- and 180-calendar day periods, selected in advance of the interest period).

[3] For more information on the ARRC's fallback language, please see our other articles in our Interest Rate Watch Series here or reach out to a member of our Banking and Specialty Finance Group to discuss.
