

Investment Company Institute response to the Financial Conduct Authority consultation on powers over use of critical benchmarks

The Investment Company Institute, including ICI Global,¹ appreciates the opportunity to provide its response to the Financial Conduct Authority (FCA) consultation on how the FCA will use its powers over critical benchmarks, such as LIBOR.² As the trade association representing regulated funds globally,³ ICI has a significant interest in the orderly transition from LIBOR benchmarks. ICI's overall priorities in evaluating proposals for LIBOR benchmark transition are:

- To support legal certainty to market participants and minimize changes to the economic value of affected contracts;
- To promote global alignment on benchmark reform to reduce potential friction and differences in regulatory or legislative approaches to transition; and
- To promote transparency with respect to the policies under the Benchmarks Regulation.

Given those overall priorities, we support the FCA in seeking to provide legal certainty for LIBOR financial contracts and financial instruments governed by the laws of a UK jurisdiction by ascertaining which new uses it will permit for a ceased benchmark (through its Article 21A powers) and what legacy uses it will permit for its expected synthetic LIBOR rates (through its Article 23C powers). We view international consistency as crucial to ensuring orderliness and certainty. We recommend that the FCA keep this consistency in mind as it moves forward, especially for benchmarks that are used widely across the globe, such as sterling and USD LIBOR.

We discuss our responses to specific consultation questions below.

¹ The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$30.8 trillion in the United States, serving more than 100 million US shareholders, and US\$9.7 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in Washington, DC, London, Brussels, and Hong Kong.

² See Benchmarks Regulation: how we propose to use our powers over use of critical benchmarks, CP21/15 (May 2021), available at <https://www.fca.org.uk/publication/consultation/cp21-15.pdf>. Specifically, the FCA requests comment on its power under Article 21A of the UK Benchmarks Regulation (BMR) to prohibit new use of a benchmark that is in the course of cessation and its power under Article 23C of the BMR to permit some or all legacy use of a benchmark that is designated under Article 23A.

³ The term "regulated funds" includes US funds, which are comprehensively regulated under the Investment Company Act of 1940, and non-US funds, that are organized or formed outside the US and substantively regulated to make them eligible for sale to retail investors, such as funds domiciled in the European Union and qualified under the UCITS Directive (EU Directive 2009/65/EC, as amended), Canadian investment funds subject to National Instrument 81-102, and investment funds subject to the Hong Kong Code on Unit Trusts and Mutual Funds.

Question 1: What kinds of provisions do you consider would lead to unintended, unfair or disruptive outcomes, or prove inoperable in practice, if a critical benchmark could no longer be used?

A full prohibition on the legacy use of LIBOR as an Article 23A benchmark (in synthetic form) would be disruptive to investors and markets. Notably, financial contracts and instruments drafted before 2017⁴ would not have envisaged the cessation or unrepresentativeness of the applicable LIBOR and may be silent on a fallback rate. Thus, we support the FCA in judiciously allowing use of a synthetic version of LIBOR to maintain orderliness in the market and to preserve the economic value of financial contracts and financial instruments governed by the laws of a UK jurisdiction and whose terms provide no alternative other than LIBOR.

We recommend that the FCA make its determination on which legacy contracts should be permitted to use synthetic LIBOR using standards that are objective and narrowly tailored. Specifically, we believe that the only criterion that the FCA should use in determining whether a financial contract or financial instrument should be permitted to use synthetic LIBOR is that the contract or instrument references LIBOR on the date the rate becomes unrepresentative and that it provides no non-LIBOR alternative rates.

For example, a financial contract that references LIBOR and has no fallback provisions should be permitted to use synthetic LIBOR. Likewise, a financial contract that references LIBOR as a floating rate and has a fallback rate to the last known LIBOR also should be permitted to use synthetic LIBOR because the financial contract does not contain a non-LIBOR fallback provision. However, a similar financial contract that falls back to a non-LIBOR rate (or does not require to a poll, survey, or quotes for interbank lending rates) should use the contractual fallback rate instead of synthetic LIBOR.

Applying such an objective criterion would permit the use of synthetic LIBOR in all financial contracts and financial instruments where it is the only option for maintaining economic value without unnecessarily substituting the use of synthetic LIBOR where it is not needed. This criterion also is self-effectuating, *i.e.*, a contractual counterparty, regulator, or authority does not need to make an additional qualitative judgment about which contracts are within scope.⁵

In contrast, we caution the FCA against applying any subjective criteria to determine which financial contracts or financial instruments would be permitted to use the synthetic rate, which can create greater uncertainty. Such subjective criteria include whether the contracts are “easy” to amend or whether parties to the contract have had “adequate” notice of LIBOR cessation. Although we acknowledge that there may be benefits to allowing a broader use of synthetic LIBOR, applying subjective criteria would inevitably lead to confusion and potentially litigation as counterparties would have to take steps to ascertain whether or not their contract or instrument meets those standards.

⁴ Andrew Bailey, FCA, The Future of LIBOR (July 2017), available at <https://www.fca.org.uk/news/speeches/the-future-of-libor>.

⁵ As discussed below, such criteria also would be consistent with approaches that regulators and legislatures in the US have taken to LIBOR transition. See, e.g., New York State act to amend the general obligations law in relation to the discontinuance of the London interbank offered rate for LIBOR (“New York legislation”), enacted April 6, 2021, available at <https://www.nysenate.gov/legislation/bills/2021/S297>.

In applying our recommended objective criterion we urge the FCA to reconsider its assumption that financial contracts or financial instruments that contain fallback provisions triggered by LIBOR “ceasing,” rather than becoming “unrepresentative,” should use the synthetic rate rather than the fallback rate that parties agreed to in their contract or instrument.⁶ The concept of a benchmark rate becoming unrepresentative, rather than ceasing altogether, has only been developed in the very recent past. Prior to policymakers socializing that concept, contractual counterparties anticipating the upcoming end of LIBOR are likely to have included fallback language providing for an agreed-upon fallback rate upon the *cessation*, rather than *unrepresentativeness*, of LIBOR. In transitioning these contracts or instruments to synthetic LIBOR rather than the contractual fallback rate, the FCA would unnecessarily overreach into private contracts. Doing so also needlessly prolongs the use of synthetic LIBOR in contracts and instruments that already have agreed-upon, viable alternative rates available and perpetuates the use of that rate in the market.⁷ Finally, the principle of contractual parties’ right to decide the terms of their contract must apply in these circumstances unless the FCA were to provide compelling reasons to supersede these agreements.

Question 4: Do you think the considerations below are relevant to determining whether it would be desirable to exercise our legacy use power?

We urge the FCA to promote international consistency in determining whether to use its powers under Article 23C. LIBORs are global interest rate benchmarks and, as a result, transition from one to another is a complex process involving numerous jurisdictions, regulatory regimes, and regulators. Given its role as the regulator of the administrator of the LIBOR benchmarks, the FCA’s decisions on the use of those rates will have inevitable extraterritorial effect. Avoiding material differences, overlaps, or gaps in coverage among the FCA’s approach and that of other global regulators would accelerate the progress of market participants’ operational readiness and reduce the opportunity for regulatory arbitrage or adverse market impacts.

We recommend that the FCA align its use of its Article 23C powers with global tough legacy solutions. Specifically, the FCA should resist uses of its powers to permit or prohibit use of an Article 23A designated benchmark, such as synthetic LIBOR, that would lead to different outcomes for financial contracts or financial instruments with substantially similar terms, issuers, and distribution patterns but governed by the laws of different jurisdictions. For example, two LIBOR notes with substantially similar terms but for their governing laws should be subject to the same criteria in every jurisdiction to determine whether those notes are within the definition of tough legacy, the timing of applying any replacement or synthetic rate to the notes, and the calculation of those rates. Misalignment of these fundamental building blocks of global tough legacy solutions has the potential to not only lead to different valuation outcomes for those otherwise identical notes but also to operational challenges for all market participants.

⁶ So long as the fallback rate meets the criterion above of itself not referencing LIBOR or requiring a poll, survey, or quotes for interbank lending rates.

⁷ Further, allowing such contracts to use synthetic LIBOR rather than a contractual fallback rate may introduce disconnects between the UK approach and how similar contracts are treated in New York or other jurisdictions.

Question 7.a: Do you think there may be situations where we could or should impose a limited form of restriction (e.g., for certain contract maturities; certain types of product or user, or after a defined time period)?

Article 21A of the BMR gives the FCA the ability to prohibit some or all new use of a critical benchmark when it is notified by its administrator that the rate will cease to be provided. We agree with the FCA that there are concerns about market participants, for example, issuing new financial products or agreeing to new contracts using a LIBOR rate that has been the subject of a cessation announcement by the benchmark administrator as a reference rate. Allowing new financial contracts or financial instruments to use a LIBOR rate that is in the process of cessation could perpetuate the use of a rate that has been declared to be in wind-down and detract from the development of markets for alternative reference rates.

As the FCA acknowledges, however, some targeted new uses of a LIBOR rate in cessation must be permitted to maintain market orderliness and prevent disruption. We agree with the FCA that it must allow some new uses of LIBOR to, for example, unwind legacy LIBOR exposures or hedge legacy exposures.

In its consultation, the FCA has noted the supervisory guidance that the US Federal Reserve Board and other US prudential regulators provided to US-regulated banks about their use of LIBOR after end-2021.⁸ In that guidance, the prudential regulators discouraged new use of USD LIBOR after that time but for limited circumstances. Those circumstances include transactions executed for purposes of required participation in a central counterparty auction procedure, market making, transactions that reduce or hedge relevant LIBOR exposures, and novations of LIBOR-linked transactions. We believe these circumstances are reasonable allowances for new use of relevant LIBORs, and we are reassured that the FCA has an eye to promoting consistency with other global approaches to new uses of those benchmarks.

We urge the FCA to go further in ensuring that there is global consistency regarding not only what types of new uses will be permitted but also which market participants are permitted to engage in those activities and for how long. Specifically, if the FCA is considering using its Article 21A powers to restrict the use by UK-regulated market participants of USD LIBOR before its June 2023 cessation date, we urge the FCA to ensure its restrictions are aligned entirely with the decision-making of relevant US regulators, including not just the prudential regulators for banks but also the capital markets regulators for those market participants and activities. Disconnects between the UK and US positions on use of USD LIBOR would cause market disruptions and confusion and should be avoided at all costs.⁹

⁸ See Statement on LIBOR Transition (November 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf>

⁹ Further, international alignment on new uses would reduce the risk of market disruptions that may occur if the FCA were to prevent UK-supervised entities from new uses of LIBOR when other global regulators do not do so for their regulated entities. For example, if the FCA were to prohibit new uses of LIBOR in circumstances where such a prohibition would trigger an illegality provision in a financial contract or instrument, UK supervised entities would bear the consequences of an unlevel playing field.