15 March 2021

Market Conduct Unit
Securities and Markets
HM Treasury
1 Horse Guards Road
SW1A 2HQ

Dear Sir or Madam

Consultation: Supporting the wind-down of critical benchmarks

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

In July 2017 a landmark speech by Andrew Bailey, then Chief Executive of the Financial Conduct Authority ("**FCA**") signalled that the official sector would withdraw support for the LIBOR benchmark at the end of 2021. Since then, the transition from LIBOR to other chosen risk-free rates has occupied the derivatives, securities and loan markets. Authorities around the world have grappled with possible methods by which they may help the market to transition away from LIBOR, especially in relation to the so-called "tough legacy" contracts--i.e., contracts that may not contain fallback arrangements for benchmark withdrawal or be easily amended. In the U.K., HM Government introduced in October 2020, the Financial Services Bill 2019-21 (the "**Financial Services Bill**"), which grants powers to the FCA to help it manage the transition of these contracts.[1] The Financial Services Bill allows the FCA to "designate" a critical benchmark that has become or is at risk of becoming unrepresentative which would give rise to a prohibition on the use of that benchmark by U.K. supervised entities.[2] To supplement these provisions, HM Treasury is considering the possibility of introducing a legal "safe harbour" for legacy contracts so as to reduce the risk of contractual uncertainty and disputes in respect of legacy contracts referencing or relying upon a benchmark that has been designated as unrepresentative by the FCA. HM Treasury has published a Consultation (the "**Safe Harbours Consultation**") on whether there is a case for introducing safe harbours and the design and scope of any such legislation.[3] This letter responds to that Consultation.

The risks arising in the context of benchmark transition

The FMLC has written extensively about the risks which may arise in relation to existing contracts upon the withdrawal of a benchmark—with or without the introduction of a replacement.[4] Withdrawal may have the effect of defeating the parties' primary

[1] The Financial Services Bill amends the existing framework governing benchmarks, provided under Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "BMR") which was brought onshore and amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018 (together the "U.K. BMR").

[2] Proposed Articles 23A and B in the Financial Services Bill

[3] HM Treasury, *Supporting the wind-down of critical benchmarks Consultation* (February 2021), available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/961317/HMT_Safe_harbour_Consultation.pdf.

[4] For an overview of the FMLC's work, please see http://fmlc.org/libor-transition/.

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expectations as those were settled at the outset of the contract and could, in the absence of targeted fallback arrangements or implied terms incorporating a successor rate, give rise to the risk of contract frustration or avoidance by reason of impossibility.[5] Alternatively, benchmark withdrawal may trigger termination or other contingency provisions of contracts—for example, force majeure clauses—in a way which is disruptive not only to the financial arrangements of the parties but, given the prevalence of market standard terms, to the markets as a whole.

Occasionally, similar concerns are expressed about benchmark transition or even about radical benchmark evolution—on the premise that the evolved benchmark or successor methodology no longer shares the identity of the original benchmark. Thus, an observer could take the view that a very significant alteration in a benchmark's methodology is best understood as a case of one benchmark succeeding another, rather than an example of benchmark continuity and evolution.

These situations are not wholly clear cut, then, but the FMLC takes the view that the risks of major market disruption are, on balance, remote, if not negligible:[6] fallback arrangements are widespread and—where incorporated—will cover any situation deemed to represent benchmark withdrawal, repapering/novation exercises in favour of new benchmarks have been undertaken diligently, market standard protocols favouring new rates have been published and the courts, which have deep experience in dealing with high-value financial contracts on standard terms, generally recognise the value of contractual continuity to financial markets counterparties. Moreover, the Common Law recognises implied contractual terms which may assist in some cases to transition a contract away from a failed benchmark and onto a successor rate even where no fallback arrangements have been incorporated.[7] For these reasons, the Committee is of the view that safe-harbour legislation would address the worst-case risks of frustration, avoidance or force majeure termination which, although they may have only a small chance of crystallising, would be potentially significant in their impact owing to the systemic importance of market standard terms.

The scope of a safe-harbour provision

HM Treasury might therefore take the view that these risks, although remote, should be closed off. It may also take the view that less alarming, but arguably more predictable, risks of litigation to pursue unmeritorious claims of frustration or avoidance or to challenge, retrospectively, an exercise of discretion with respect to the lawful selection or use of a benchmark should also be addressed.

If so, a safe-harbour provision can usefully be enacted. The FMLC recommends that such a provision tracks established approaches to this issue as closely as possible and draws attention in this regard to Article 68 of Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the "**BRRD**"), which implements the so-called "general stay" on the termination of

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[5] This risk materialises when the subject matter of a contract has been destroyed, or has otherwise become unavailable, and as a consequence the performance of the contract by one or both parties is rendered impossible.

[6] The FMLC has expressed this opinion in previous publications. More in-depth analysis may be found in Letter to the Bank of England on Reform of SONIA (30 December 2016), available at: http://fmlc.org/letter-to-bank-of-england-benchmarks-reform-30-december-2016/

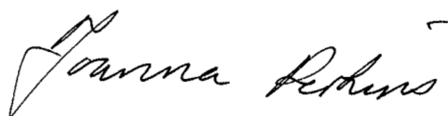
[7] The FMLC understands that market standard terms exist for certain loans (made available by the Loan Market Association) and for derivatives (by ISDA) but they are not uniformly adopted, particularly where bilateral agreements are concerned or where there is specialist debt finance in the leveraged, infrastructure, emerging and bond markets.

contracts during resolution. (For a draft safe-harbour provision modelled on this article, please see Appendix I below)

If a safe-harbour is implemented, it should, for the sake of legal certainty, apply widely to all types of financial instruments, including corporate and syndicated loan contracts, contracts with non-supervised entities and other contracts which do not fall within the scope of the BMR. For the same reason, a safe-harbour provision should not interfere with contractual fallback clauses. Finally, safe-harbour legislation should only apply to contracts governed by English law or the law of another U.K. jurisdiction, in order to avoid irresolvable conflicts of law issues.[8]

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

Yours sincerely,



Joanna Perkins[9]
FMLC Chief Executive

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8 Different criteria have been used in draft and extant measures to minimise perceived contractual continuity risks around LIBOR transition in the E.U., U.K. and U.S.. In consequence, the measures themselves overlap and the same arrangements may potentially be subject to conflicting laws concerning benchmark transition and contract continuity. As such, there is already heightened risk of forum-shopping. This risk might be reduced by HM Treasury and the FCA through coordination with counterparts in other relevant jurisdictions.

9 The FMLC is grateful to David Bunting (Deutsche Bank), Patrick Chamberlain (Goldman Sachs), Hamish Patrick (Shepherd and Wedderburn LLP), and Elizabeth Williams (Simmons & Simmons LLP) for their comments on a previous draft of this letter.

APPENDIX I: DRAFT SAFE-HARBOUR PROVISION

Description:

Exclusion of certain contractual terms and doctrines in the event of the designation, termination and/or modification of an unrepresentative benchmark under the Financial Services Act.

Main content:

1. The exercise of a statutory power in relation to a benchmark in accordance with the Act, including the occurrence of any event directly linked to the application of such an exercise, shall not, per se, under a contract referencing that a benchmark, be deemed to be grounds for the frustration, avoidance, discharge or automatic termination of the contract or of a party's obligations thereunder.

2. Provided that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed, the exercise of a statutory power in relation to a benchmark in accordance with the Act, including the occurrence of any event directly linked to the application of such an exercise, shall not, per se, make it possible for a person to:

(a) exercise any termination, suspension, modification, netting or set-off rights,

(c) rely on any contractual provision or rule of law to excuse non-performance on grounds of impracticability, impossibility, or frustration of purpose

(b) obtain possession, exercise control or enforce any security over any property of anyone in relation to the contract

(c) affect any contractual rights in relation to the contract other than in accordance with sub-section 4 below.

3. This section shall not affect the right of a person to take an action referred to in paragraph 2 where that right arises by virtue of an event other than the exercise of a statutory power in relation to a benchmark in accordance with the Act or the occurrence of any event directly linked to the application of such exercise.

4. This section shall not affect the right or duty of a person to use any benchmark, index or rate, including a benchmark designated under section 23A, in accordance with the terms of a contract entered into before that designation. A person who uses a benchmark designated under section 23D of the Act in accordance with the terms of such a contract shall not be liable for any losses that arise directly or indirectly as a result of the exercise of a statutory power under section 23.