Response to FCA Consultation: new powers over use of critical benchmarks under the Benchmarks Regulation

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Financial Markets Law Committee

Working Group[1]

David Bunting	Deutsche Bank AG
Patrick Chamberlain	Goldman Sachs
James Mervyn	Sidley Austin LLP
Kate Scott	Clifford Chance LLP
Elizabeth Williams	Simmons & Simmons LLP
Brian Gray	Interim Chief Executive
Venessa Parekh	Research Manager

1 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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1. INTRODUCTION

1.1. 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.

1.2. In July 2017, the FCA announced that it would not guarantee the survival of the London Inter-Bank Offered Rate ("**LIBOR**") after the end of 2021. The transition from LIBOR to other chosen risk-free rates has occupied the derivatives, securities and loan markets and early market engagement around the question of establishing term rates has proven particularly challenging. 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 those legacy contracts which may not contain a fallback clause or be impractical to amend ("tough legacy contracts").

1.3. In the U.K., new powers were granted to the Financial Conduct Authority ("**FCA**") under the Financial Services Act 2021 (the "**Financial Services Act**") which would help it manage an orderly "wind-down of critical benchmarks" and facilitate the transition of tough legacy contracts. The Financial Services Act 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**") under the European Union (Withdrawal) Act 2018 so as to make adjustments to the BMR for the purposes of Brexit. The FCA is consulting on its proposed use of two new powers.

1.4. First, the Financial Services Act introduces a new Article 23A into the U.K. BMR, enabling the FCA to designate a critical benchmark that had become unrepresentative, or was at risk of becoming unrepresentative, as an "Article 23A benchmark". The designation, under new Article 23B, also introduced by the Financial Services Act, would give rise to a prohibition on the use of that benchmark by U.K. supervised entities. New Article 23C(2) allows the FCA to provide an exemption from the prohibition on the use of the designated benchmark in respect of, for example, tough legacy contracts (known hereafter as the "legacy use" power). The designation would also empower the FCA, under new Article 23D, to take certain actions including requiring changes to the benchmark's methodology for any continued use. Thereafter, in respect of a designated benchmark, the FCA is given the power to make rules concerning its continued use in certain legacy contracts. The second new power given to the FCA is the ability, under new Article 21A, to prohibit some or all new use of a critical benchmark when it has been notified by its administrator that it will cease to be provided (the "new use" power).

2. ISSUES OF LEGAL UNCERTAINTY

2.1. Two preliminary issues arise in the wider context of the BMR, clarification on which would provide greater certainty to market participants amidst the upheaval of LIBOR transition. First, the FMLC would highlight longstanding uncertainty in relation to the meaning of "use under the BMR, which referred to "use in E.U." The phrase has been onshored under U.K. BMR as "use in U.K." In the context of cross-border transactions, especially where branch structures are involved, uncertainties arise around how the site of "use" should be determined. The uncertainty arises again, in the context of the FCA's new transition powers, in relation to clause 2(b) of new Article 21A of U.K. BMR.[2] In considering prohibiting legacy use and new use of a benchmark, embellishment on the definition of "use" would be helpful. While the European Securities and Markets Authority ("**ESMA**") has provided some guidance on definition of "use" under the BMR by means of its Question and Answer document,[3] it is unclear whether that guidance will apply in the U.K. under U.K. BMR or whether the FCA will

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2 Clause 2 of new Article 21A provides:

> In paragraph 1, the reference to new use of a benchmark is to doing the following on or after the day on which the prohibition takes effect ("the prohibition day")
>
> (a) issuing a financial instrument which references the benchmark, or amending the terms of a financial instrument so as to include a reference to the benchmark where the instrument did not reference the benchmark immediately before the prohibition day;
>
> (b) determining the amount payable under a financial instrument or a financial contract by referencing the benchmark, where the instrument or contract did not reference the benchmark immediately before the prohibition day;

3 ESMA, *Questions and Answers on the Benchmarks Regulation (BM*R), version 19 (last updated 28 May 2021, available at: https://www.esma.europa.eu/press-news/esma-news/esma-updates-qa-benchmarks-regulation. See Q&A 5.2

provide its own guidance, potentially addressing uncertainties arising from the ESMA Q&A.[4]

2.2. Secondly, the differing approaches taken by authorities in key financial services jurisdictions gives rise to a pressing problem of potential conflict and overlap, which the FMLC has highlighted previously. The FCA lists international consistency amongst the additional factors it will take into account when reaching a view on whether or not to exercise its new powers. In response to questions 4 and 9, which asks for thoughts on these additional factors in respect of the FCA's legacy use and new use powers respectively, the FMLC would query whether, in considering the nature and scope of tough legacy contracts in the context of market integrity, the FCA will consider the extent to which not providing a permission would lead to uncertainty in the operation of contracts between U.K. regulated entities and counterparts who are not U.K. supervised entities. The designation of an Article 23A benchmark by the FCA will only prevent U.K. supervised entities from using that benchmark, possibly creating an uneven field whereby, if there is no general permission to use synthetic LIBOR in legacy products, FCA supervised entities are disadvantaged and may be forced to (i) apply uncommercial fallbacks such as costs of funds or last known fixing, where available, (ii) pay excessive amounts to agree consensual termination or redemption, (iii) invoke termination/redemption language, leading potentially to disputes, or (iv) where none of those options exist, choose between defaulting on contractual obligations or being in regulatory breach. The FMLC would reiterate its previous recommendation to liaise and co-ordinate where possible with overseas regulators to ensure an alignment of outcomes to the degree possible within the differing frameworks.[5]

Legacy use

2.3. Question 1 of the Consultation asks which kinds of provisions in contracts would lead to unintended, unfair or disruptive outcomes, or prove inoperable in practice. 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 new replacement one.[6] Of particular concern is the loss of legal certainty and the

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4 One example of an uncertainty which ESMA has tried to resolve via its Q&As concerns the definition of "financial instrument", in particular in relation to whether a derivative has been "traded … via a systematic internaliser".

5 See: EFMLG and FMLC, Joint Letter: LIBOR transition, (19 March 2021), available at: http://fmlc.org/efmlg-and-fmlc-joint-letter-libor-transition-19-march-2021/.

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

possible effect of defeating the parties' primary expectations as settled at the outset of a contract. Benchmark withdrawal has potentially profound and far-reaching consequences for the integrity of markets.

2.4. Since the FCA's 2017 announcement, the transition from LIBOR to other chosen risk-free rates has occupied the derivatives, securities and loan markets. Despite market efforts towards the development of market protocols and standard contractual arrangements, certain categories of contracts will continue to reference LIBOR.[7] For example, while uptake of the ISDA IBOR Fallbacks Protocol has been high amongst market participants, there remains a minority group of entities which will not be able to adhere to the Protocol or effect the required bilateral amendments. This may be because they are transaction vehicles and lack the internal authority to make amendments, being beholden to the agreement of reluctant trustees or unidentified bondholders, or because LIBOR transition is less of a priority for smaller, non-financial end users of derivatives from whom financial institutions struggle to get a response. In addition, protocols will not mitigate uncertainty in respect of linked transactions—i.e., a loan and swap—as they need to transition at the same time and in respect of asset classes with less standardised documentation.

2.5. There are a variety of reasons certain bonds may fall within the "tough legacy" bucket: while consent solicitation processes have been followed by the most sophisticated issuers, who presumably know their investor base, other issuers will not generally know the identity of their bond-holders at any given time. Where bonds are held by retail investors, consent solicitation may be difficult or ineffective. Special purpose vehicle issuers will not initiate the process themselves, and may be beholden on the rate changing in underlying collateral before they are able to act. The points above illustrate a general point that it will important to ensure contracts are not considered in isolation and are viewed in the context of the broader transaction to which the relevant contract belongs. For example, in a securitisation, it should only be deemed that is feasible to transition the notes if it is feasible to transition any corresponding collateral and/or swaps.

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7 See, for example, the ISDA IBOR Fallbacks Supplement and Protocol at ISDA, Press release: "ISDA launches IBOR Fallbacks Supplement and Protocol", (23 October 2020), available at: https://www.isda.org/2020/10/23/isda-launches-ibor-fallbacks-supplement-and-protocol/. Similarly, the Loan Market Association has published a suite of documentation to facilitate the syndicated loan market in transitioning away from the use of LIBOR to compounded RFRS; see: LMA, LMA publishes further RFR documentation to assist the market with LIBOR transition, available at: https://www.lma.eu.com/application/files/4616/2220/6357/Member_alert.pdf.

2.6. In addition to the difficulties in repapering or amending contracts, set out above, the FMLC would highlight the existence of contracts which require a third party to determine a new reference rate but in relation to which no third party can be identified. Another example would be contracts which effectively switch to a fixed rate (for example, the last published rate) are likely to yield results at odds with the parties' commercial expectations of a dynamic rather than static rate. Typically, legacy contracts will have not anticipated that benchmark use would be a regulated activity or that regulatory permission could be denied, as a result of which termination clauses may not work adequately.

2.7. The position of service providers is overlooked by the Financial Services Act architecture. Trustees, Calculation Agents and Facility Agents may be required to select a successor rate and/or balancing payment, using a degree of judgment. The legislation adopted by the New York State Senate to address the cessation of USD LIBOR provides a safe harbour for those service providers transitioning as provided by the legislation.[8] U.K. service providers transacting under other governing laws do not, however, benefit from safe harbours, which may lead either to paralysis, if they are reluctant to act, or heightened litigation risk, if parties feel the wrong steps were followed.

2.8. The wide range of contracts and causes leading to their classification as "tough legacy" means that it is likely to be challenging to delineate cleanly which contracts should fall within the FCA's Article 23C powers, giving rise to a greater degree of uncertainty amongst market participants.[9] It is possible that a benchmark is prohibited for legacy contracts in circumstances where market participants are not in a position to amend contracts, leading to an incorrect categorisation of the contract as being capable of amendment. Were the FCA to opt to circumscribe tightly the circumstances in which legacy use of an Article 23 benchmark is permitted, it might require firms to make unilateral or subjective determinations, reducing legal certainty and putting market integrity at risk. In using its legacy use powers, therefore, the FMLC would urge the

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8 Senate Bill 297B/Assembly Bill 164B

9 The FMLC would highlight the work of the Working Group on Sterling Risk-Free Reference Rates on the identification of tough legacy issues. See: Working Group on Sterling Risk-Free Reference Rates, Paper on the identification of Tough Legacy issues (May 2020), available at: https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/paper-on-the-identification-of-tough-legacy-issues.pdf

FCA to take into consideration the complex nature of contractual arrangements in the financial markets and take a generous approach to the definition of "tough legacy".

2.9. The FCA has also set out the factors it will take into consideration when determining whether and to what degree it is feasible for parties to amend legacy contracts. Question 2c of the Consultation asks whether there are other relevant factors to take into account for such a determination. As set out above, there will be a population of contracts, including derivatives, for which the parties required to effect the relevant amendments are not willing to engage in the process or are unresponsive to attempts to contact them. Given the significance to both parties of no longer being able to use LIBOR in a contract, these factors militate in favour of the generous approach to the definition of "tough legacy", referred to, above.

2.10. In order to assist in promoting market clarity (and in response to questions 4 and 5), it would be helpful if the FCA's policy approach would address the following questions:

- where legacy use is permitted, in what circumstances would it be acceptable not to even attempt to migrate away from the Article 23A benchmark (for example, because it is clearly not possible)?
- alternatively, if the FCA was to require that supervised entities use reasonable efforts to attempt migration first, it would be helpful to market participations for the FCA to provide examples of the types of actions it believes constitute "reasonable efforts" (i.e., for a bilateral product, trying to negotiate with the other party or, for notes, undertaking a consent solicitation process)

2.11. Finally, the FCA states that it may consider permitting only a limited form of use of the legacy benchmark in some cases. One example of the "limited use", set out in the Consultation, is by permitting use of the benchmark for a time limited period after the prohibition takes effect. In response to question 3, which asks for thoughts on "limited use", legal certainty would be enhanced if the FCA provided guidance that time limited use would only be appropriate where the issues preventing migration could feasibly be solved or eradicated within the time-period—for example, for the purposes of termination payment or to deal with contracts close to maturity or when a contract could be transitioned to an alternative rate but this cannot be achieved by the current deadline (particularly relevant in the context of several simultaneous consent solicitation processes).

3. CONCLUSION

3.1. The FMLC has written extensively about issues of legal uncertainty arising in the context of LIBOR transition and has commented previously on steps taken by UK authorities to help the market transition away from LIBOR. In this response to the FCA's Consultation on its new powers over the use of critical benchmarks, the FMLC has highlighted uncertainties in relation to the BMR generally, which in turn lead to confusion regarding the new powers and the difficulties in defining the "tough legacy" contracts in relation to which the FCA may use its new powers. In relation to the latter, in particular, the FMLC would urge the FCA to adopt a generous approach to the definition of "tough legacy".

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Brian Gray (Chief Executive)

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