INVESTMENT COMPANY INSTITUTE® ICI Global

Investment Company Institute response to the Financial Conduct Authority consultation on Article 23D under the new UK Benchmarks Regulation

The Investment Company Institute, including ICI Global,[1] appreciates the opportunity to provide its response to the Financial Conduct Authority (FCA) consultation on the proposed policy with respect to its exercise of powers under new Article 23D of the UK Benchmarks Regulation (UK BMR).[2] New Article 23D, if adopted, would grant the FCA the ability to impose requirements on the administrator of a designated critical benchmark, including changes to its methodology.

As the trade association representing regulated funds globally,[3] ICI has a significant interest in the orderly transition from LIBOR benchmarks. We reviewed new Article 23D with a view to its potential impact on and interaction with, among other concerns:

- The identification and adoption by the relevant market of appropriate fallback language and replacement benchmark rates;
- Derivatives contracts covered by the ISDA 2020 IBOR Fallbacks Protocol; and
- The availability and adequacy of market, regulatory, or legislative solutions for dealing with tough legacy contracts.[4]

[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$27.7 trillion in the United States, serving more than 100 million US shareholders, and US$8.3 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *See* Consultation on proposed policy with respect to the exercise of the FCA's powers under new Article 23D (November 2020), *available at* https://www.fca.org.uk/publication/policy/consultation-exercise-fca-powers-new-article-23d.pdf. ICI notes that this response to the consultation should be read in conjunction with its response to the concurrent FCA consultation on proposed new Article 23A.

[3] The term "regulated funds" includes US funds, which are comprehensively regulated under the Investment Company Act of 1940 (Investment Company Act), 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.

[4] For the purposes of this submission, "tough legacy" contracts are contracts referencing a LIBOR currency/tenor pairing referencing a discontinued or non-representative benchmark and that are still in force at the date of cessation of the benchmark.

ICI's overall priorities in evaluating proposals for benchmark transition are:

- To support proposals that provide 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 developed by the FCA about the manner in which it would exercise its powers under the UK BMR.

Given those overall priorities, ICI recommends that the FCA engage with global policymakers and market participants to ensure its proposed use of its powers under the UK BMR align with the approaches being taken in other jurisdictions. Further, we recommend that the FCA continue to provide notice and guidance to the market on its use of its powers under the UK BMR and other benchmark transition developments. We discuss these recommendations as well as our responses to specific consultation questions in further detail below.

Global Alignment

LIBORs are global interest rate benchmarks and, as a result, transition from one to another is a complex process involving numerous legal jurisdictions, regulatory regimes, and regulators. Avoiding material differences, overlaps, or gaps in coverage among the approaches to benchmark transition across the globe would minimize the risk of litigation, accelerate the progress of market participants' operational readiness, and reduce the opportunity for regulatory arbitrage or adverse market impacts.

ICI recommends that the FCA consider the potential consequences of exercising its Article 23D power with respect to a LIBOR currency/tenor pairing both within and outside the UK. We recommend that the FCA seek and act on input from other global regulators, central banks, and private sector risk-free working groups to align approaches to the extent possible. We particularly recommend alignment in approaches determining which contracts will be permitted to use a replacement or "synthetically" calculated rate, when fallback language would be triggered by announcements of cessation or non-representativeness, and how to align replacement or synthetically calculated rates covering the same LIBOR currency/tenor pairing across jurisdictions. We recognize that such alignment may be challenging given the nascent stage of wind-down in several LIBOR currency jurisdictions and recommend that the FCA be mindful of the timing of acting on its expected powers.

Market Guidance

To further promote LIBOR transition, the FCA should provide a potential timeline or decision tree regarding its likely outcomes and next steps following the enactment of the UK BMR. Such a timeline would be useful for market participants to understand the anticipated interplay of the FCA's use of its powers with other global consultation processes, such as the ICE Benchmark Administrator's proposed cessation of the publication of LIBOR currency/tenor pairings and the

new powers to be granted pursuant to the amendments proposed to be made to the EU Benchmarks Regulation.[5]

ICI also recommends that the FCA consider providing tailored guidance for asset managers and buy-side firms. While this part of the industry has been monitoring and moving forward with their LIBOR transition programs, it would be helpful to understand regulators' current expectations for the steps and timeframes for transition programs as LIBOR cessation dates approach.

Responses to Specific Questions

Question 1: Do you have any view on how best to consult in respect of our prospective decisions to exercise our Article 23D(2) power in respect of LIBOR?

Article 23D(2) would empower the FCA to mandate an alternative methodology for determining LIBOR. Although one element of the alternative methodology for a LIBOR currency – a risk-free rate – could be gleaned from the rates recommended by central banks and working groups in that currency's home jurisdiction, a core challenge remains in determining the spread over the risk-free rate that allows the alternative methodology to replicate a LIBOR rate. We note that the FCA proposes following the approach taken by ISDA in setting a spread adjustment.[6] Although we agree that such a spread adjustment has gained wide market acceptance, we recommend that the FCA take a holistic approach in ensuring that that spread adjustment is workable for all cash as well as derivative products. To the extent that the FCA proposes to adopt an alternative methodology policy differing from approaches that are being used in the market, the FCA should provide its reasons for adopting that approach and provide sufficient time for market participants to amend affected positions accordingly.

Although ICI appreciates that any alternative methodology developed utilizing the new Article 23D power is intended only to be used in permitted legacy contracts, the extraterritorial impact of this power could have an impact on the effectiveness of interest rate and currency hedges taken out with respect to affected cash products and the progress of benchmark transition globally. Although we would prefer that the impact of the FCA's actions be limited to UK-law governed contracts in order to promote legal certainty, given the overall UK approach to the wind-down, extraterritorial impact may not be easily limited. Accordingly, we welcome the FCA's indication that it will continue to liaise closely with the home country regulators and risk-free rate working groups for relevant LIBOR currencies.

[5] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 as amended, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02016R1011-20191210&from=EN. We note there is a risk of a conflict of law given the purported right under the amended EU BMR to impose a statutory replacement rate on certain contracts to which only parties established in an EU member state are a party, notwithstanding that the governing law of those contracts is not the law of an EU member state.

[6] That is, a "5-year historical median of the spread between the relevant IBOR and relevant RFRs, which is then added to the RFR. Our provisional view is that this is a fair and robust way of approximating the outcome delivered by LIBOR." *See* Consultation at 3.

Question 2: How should we evaluate the practicality of transition and the scale of "tough legacy"?

To evaluate the scale of tough legacy contracts, the FCA must first determine what it considers to be a tough legacy contract.

ICI recommends that the FCA align with other global policymakers and market participants in categorizing contracts as tough legacy to ensure that contracts are treated consistently across jurisdictions, or at least consistently for the particular governing law and type of contract. Given the number of challenges already embedded in the LIBOR transition process, any indication that the various regulators and legislators will choose different methods of approaching tough legacy contracts would introduce more uncertainty, and more complex requirements on issuers and investors seeking to achieve an orderly transition.

In particular, we recommend that the FCA consider the approach of the Alternative Reference Rate Committee (ARRC) in the United States, which would apply its proposed tough legacy solution to contracts and financial instruments with either no fallback language for the discontinuation of LIBOR or with fallback language that depends on LIBOR.[7] Such an approach would have the benefit of being narrowly tailored to those contracts that are inextricably linked to LIBOR without overriding other contractual language. In addition, this approach is self-effectuating and reduces the need for subjective interpretation about whether a particular contract should be considered tough legacy.

Finally, we recommend that the FCA continue to encourage reducing the potential pool of tough legacy contracts by market participants transitioning LIBOR-referencing contracts before the cessation of a LIBOR currency/tenor. ICI supports the FCA's previous exhortations to market participants to engage in active transition. All relevant regulators should continue to encourage active transition wherever possible.

Question 3: Do you agree that the scale of "tough legacy" must be significant in order to justify intervention?

ICI does not believe that the scale of tough legacy contracts must be “significant” to justify an FCA intervention. FCA using its powers to transition any number of tough legacy contracts that exist as of the date of LIBOR cessation would be consistent with the FCA’s mandates to protect investors and uphold market integrity.

As for the measurement and quantum of the scale of tough legacy contracts, ICI encourages the FCA to be transparent with the data sets it uses for determining tough legacy with respect to particular LIBORs, and to disclose its determination of relevant data sets in its Article 23D policy. ICI also recommends that any policy used by the FCA to determine tough legacy products make clear the basis on which such analysis and decision-making is based.

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[7] *See* Alternative Reference Rates Committee, Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition (2020), *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf.

Question 4: Under what circumstances might orderly transition be achieved without the use of Article 23D powers?

We note that, in lieu of using its Article 23D powers to provide an alternative methodology, it may be possible for the FCA to use, if necessary, its Article 23(6) powers to compel panel banks to continue to submit data to the benchmark administrator. We recommend that the FCA provides more detail on the circumstances in which the FCA may use these powers rather than designate an affected benchmark to use its Article 23D powers. The FCA should provide transparency over its decision-making process in such circumstances.

Question 5: Do you have any views on how we intend to consider whether intervention is desirable?

We have no comment on this question.

Question 6: Do you think we have identified all the relevant factors?

At this point in time, it may not be possible to identify all the relevant factors regarding the use of Article 23D. The legislation authorizing these powers has not been enacted, the market continues to make progress on transition, and other affected jurisdictions are embarking on their own benchmark transition solutions. These changeable and evolving circumstances reinforce the necessity and utility of the FCA providing adequate notice to the market and further consultations on the exercise of any of the powers currently and in the future available to it to facilitate an orderly transition from LIBOR.

Question 7: Are there any further issues which we need to consider in our approach to using our powers?

We have no comment on this question.