

Investment Company Institute response to the Financial Conduct Authority consultation on proposed decisions on the use of LIBOR

The Investment Company Institute, including ICI Global,¹ appreciates the opportunity to respond to the Financial Conduct Authority (FCA) consultation on its proposed decisions regarding the use of Benchmarks Regulation (BMR) Articles 23C and 21A.² The FCA has stated that most currencies of LIBOR, including UK sterling and Japanese yen rates, will no longer be representative as of end-2021 and most US dollar LIBOR settings will no longer be representative after June 2023.³

As the trade association representing regulated funds globally,⁴ many of which invest in securities referencing LIBOR, 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 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 BMR.

We recognize that 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 for the administrator of LIBOR, FCA decisions will have

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\$ 32.4 trillion in the United States, serving more than 100 million US shareholders, and US\$ 10.1 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 Proposed decisions on the use of LIBOR (Articles 23C and 21A BMR), available at <https://www.fca.org.uk/publications/consultation-papers/cp21-29-proposed-decisions-libor-articles-23c-21a-bmr>.

³ See FCA Announcement on future cessation and loss of representativeness of the LIBOR benchmarks ("Cessation announcement") (March 2021), available at <https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf>.

⁴ 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.

inevitable extraterritorial effect. Avoiding material differences, overlaps, or gaps in coverage among the FCA's approach and that of other global regulators will accelerate the progress of market participants' operational readiness and reduce the opportunity for regulatory arbitrage and adverse market impacts. To prevent market disruption, we believe the FCA must continue to collaborate with global regulators to avoid any regulatory or legislative solutions that would lead to different valuation outcomes for financial contracts or instruments with substantially similar terms, issuers, and distribution patterns but governed by the laws of different jurisdictions.

Given our priorities and perspective, we commend the FCA for ascertaining which contracts will be considered legacy after end-2021. We similarly appreciate the FCA's efforts to align the use of US dollar LIBOR rates by UK supervised entities with the guidance several US regulators have provided for US banks.⁵ As discussed above, we view international consistency as crucial to ensuring orderliness and avoiding market disruption. We recommend that the FCA continue to work with other jurisdictions to align tough legacy solutions as it moves forward, especially for benchmarks that are used widely across the globe, such as sterling and US dollar LIBOR.

We discuss our responses to specific consultation questions below.

Question 1: Do you agree with the manner in which we propose to exercise our legacy use power?

We commend the FCA in permitting legacy contracts to use 1-, 3-, or 6-month sterling and yen LIBOR rates, computed through synthetic methodology for a year. We agree that some contracts and instruments may mature during that year, and perhaps others can be renegotiated for a different rate during that timeframe. We note, however, that the barriers to amending certain contracts and instruments, such as the consent requirement for amending certain bonds, will continue to present obstacles to updating those instruments' reference rates, possibly after 2022. As a result, we urge the FCA to be open to continuing the publication of synthetic sterling and yen LIBORs beyond 2022 for any contracts and instruments that remain legacy after that time.

Question 3: Do you agree that we have identified correctly the main groups of contracts that do not currently contain adequate provisions to deal with a prohibition on use?

We support the FCA's proposal to permit legacy use of these six synthetic LIBOR settings in all contracts except cleared derivatives (whether directly or indirectly cleared).⁶ As buy-side participants who purchase, sell, or hold instruments that may reference sterling or yen LIBOR rates, ICI and its members believe this comprehensive definition of tough legacy best promotes smooth transition for the market and reduces litigation risk for investors.

We remain concerned, however, that even this expansive approach will still leave overlaps and gaps where a contract is governed by a legacy solution under one jurisdiction but some parties to the contract are governed by a conflicting tough legacy solution under another jurisdiction. Overlaps and gaps arise from the international reach of markets, where transactions may involve market participants and legal documents from several jurisdictions. Overlaps and gaps also arise from the

⁵ See Statement on LIBOR Transition (November 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf>.

⁶ We further recommend that the FCA provide market guidance to assure market participants that sterling and yen LIBOR referencing swap rates are intended to be allowed to use synthetic LIBOR rates on the same basis as other legacy contracts and instruments.

friction when one jurisdiction's legacy solution applies to entities it regulates (such as the FCA's powers under the BMR) and another's application to contracts governed by the law of that jurisdiction (such as the New York state legislation).⁷ We recommend that the FCA coordinate with other regulators to determine an aligned approach and provide guidance to the market, including for UK supervised entities that are parties to contracts or instruments governed by the laws of another jurisdiction, resulting in:

- *Conflict between the FCA legacy solution and a conflicting legacy solution in the contractual governing law jurisdiction.* UK supervised entities may be parties to legacy contracts governed by the laws of other jurisdictions that have enacted or regulated a different LIBOR legacy solution, creating confusion about whether the BMR and FCA regulation or the tough legacy solution enacted by another jurisdiction should apply. Given these circumstances, the FCA should work with global regulators to provide aligned guidance on whether the jurisdiction of the entity's supervision or the contractual governing law would apply to the contract's benchmark transition. Further, we recommend that the FCA and other global regulators endeavor to align their tough legacy solutions so that legacy contracts are treated consistently regardless of the jurisdiction regulating contractual parties or governing contracts and instruments.
- *Confusion when the FCA legacy solution applies to some contractual parties, but the contractual governing law jurisdiction lacks a legacy solution.* Although the FCA provides a solution for UK supervised entities' ongoing use of sterling or yen LIBOR in legacy contracts, the laws of a different jurisdiction governing the contract may not have a legacy solution for those rates. For example, although New York state has adopted a tough legacy solution, it only applies to US dollar LIBOR and does not address the steps parties must take to transition New York law governed contracts referencing sterling or yen LIBOR. Further, many other jurisdictions have not adopted tough legacy solutions at all. It is not clear what happens in these circumstances when sterling and yen LIBOR become unrepresentative at the end of 2021. As a result, these contracts may have very different valuation outcomes in each jurisdiction although they may be otherwise similar. As the global regulator for the LIBOR administrator, we urge the FCA to coordinate with other regulators to provide guidance on how legacy contracts that fall between the gaps should be considered.⁸

Question 5: Do you agree with the manner in which we propose to exercise our new use restriction power?

We agree with the FCA that there is good reason to prevent UK market participants from issuing new financial products or agreeing to new contracts using a LIBOR rate that will be ceasing. Doing so would only perpetuate the use of that rate in the market and detract from the development of markets for alternative reference rates. Thus, we generally support the FCA's proposed restrictions

⁷ See New York State Senate Bill S297B (January 2021), available at <https://legislation.nysenate.gov/pdf/bills/2021/S297B>.

⁸ We are also aware there are loans that may be governed by the laws of England & Wales, but not subject to the BMR because those contracts are not entered into by UK supervised entities or are not regulated instruments. We similarly recommend that the FCA work with other regulators to provide guidance on how these contracts should approach transition.

on UK supervised entities' new use of US dollar LIBOR as of end-2021, although most settings of the rates using the current methodology will not cease until June 2023.⁹

We also commend the FCA in endeavoring to align its restrictions for UK supervised entities and contracts within the BMR, with the supervisory guidance that the US Federal Reserve Board and other US prudential regulators provided to US-regulated banks. Given the importance of the US dollar LIBOR benchmark to both countries, it is important to align the approaches as much as possible to reduce confusion and increase certainty for contractual validity. We are reassured of the FCA's commitment to promoting consistency in restricting new use of US dollar LIBOR.

However, there remain differences in the approaches between the FCA and the US regulators, specifically in the type of entities in each jurisdiction that are subject to the restriction. In the US, the prudential regulators' supervisory guidance applies only to banks entering into new contracts using US dollar LIBOR as a reference rate. In contrast, the FCA restrictions would apply to a wider array of UK supervised entities, including investment firms, UCITS management companies, and alternative investment fund managers (AIFM).¹⁰ The disconnects in affected parties could lead to some market participants being prohibited from using a rate while others continue to do so.¹¹

Separately, the FCA's proposal notes the importance of aligning the exceptions to its restriction on new use with those in the existing US supervisory guidance. We agree that the exceptions should be aligned and agree that the exceptions enumerated by both the FCA and US prudential regulators are reasonable allowances. Although the FCA's proposal adds an additional exception for interpolation, we support this additional exception as helpful to market participants.¹²

Question 7: Do you have any other views or comments on our proposed decision to exercise our new use restriction power?

We recommend that the FCA, as the regulator for the administrator for US dollar LIBOR, take further steps to bolster the smooth transition for those rates in collaboration with US regulators.

First, although the FCA's consultation notes that it expects panel banks to continue to submit through mid-2023, without a material change to input data, we recommend that the FCA provide certainty that US dollar LIBOR will remain a representative rate through June 2023. For example, the FCA can provide clarity of the procedures it will use to continue to support the rate should one or more of the panel banks withdraw from submission before that date.

Relatedly, the FCA's consultation does not address whether the FCA would use its powers to compel a synthetic methodology for UK supervised entities to use US dollar LIBOR rates should

⁹ We note that two US dollar LIBOR settings, 1-week and 2-month, will cease end-2021 while the remaining overnight, 1-month, 3-month, 6-month, and 12-month setting will cease end-June 2023. See Cessation Announcement.

¹⁰ Article 3(1)(17) of the BMR.

¹¹ Further, there may be a risk of market disruptions 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.

¹² Interpolations are terms within certain contractual fallbacks whereby a ceasing version of a benchmark, such as 1 week and 2-month US dollar LIBOR, would switch to a non-ceasing version of the same benchmark, such as overnight US dollar LIBOR. Although the FCA's allowance for interpolations is an additional exception to the prohibitions on new use established by the US prudential regulators, we recommend adding this exception as it promotes orderly transition.

they become unrepresentative or when they cease after June 30, 2023. We believe the FCA should consider doing so. We expect that there will be many contracts and instruments using these rates in the UK that would be legacy at the time of the rate's unrepresentativeness or cessation. Although potential federal legislation in the US may provide a fallback rate for contracts and instruments governed by the law of a State in the US, that would not be the case for contracts and instruments governed by the laws outside the US or provide a process for smooth transition for UK supervised entities. Failure to plan for UK supervised entity legacy use of US dollar LIBOR rates that become unrepresentative or cease publication risks UK market disruption.

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