ISDA® Safe, Efficient Markets

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HM Treasury – consultation on supporting the wind-down of critical benchmarks

The International Swaps and Derivatives Association (ISDA) and its members welcome the opportunity to respond to HM Treasury's consultation on supporting the wind-down of critical benchmarks[1].

ISDA has been instrumental in supporting international and regional efforts to ensure the orderly transition of derivatives contracts away from LIBOR and other benchmarks and has developed multilateral protocols and supplements to facilitate such an orderly transition.

Consistent with our mission, our responses to Her Majesty's Treasury are primarily focussed on ensuring the safety and efficiency of the financial markets with respect to derivatives and other financial transactions. As a result, we have responded to only those questions that are most relevant to that mission.

The views set out in this response are based on the aggregated and anonymized views of ISDA's members and its staff. Thus, these responses reflect the input of ISDA staff and members of the ISDA Americas and Europe Benchmark Working Group; ISDA APAC Benchmark Working Group; ISDA Article 28(2) EU Benchmark Regulation Group; ISDA EU Benchmarks Regulation Advocacy Group; ISDA Commodity Derivatives Working Group; ISDA Documentation Group; ISDA European Government Relations Working Group; ISDA Interest Rates Legal Group; ISDA Interest Rates Steering Committee; ISDA JPY Benchmark Working Group; ISDA Rates Market Infrastructure Working Group. While ISDA solicited the views of all of its members in each of these Working Groups, not all members responded and not all members of ISDA are members of these working groups. Not all members who provided feedback responded to all of the questions. These responses may not, therefore, reflect the full range of views held by ISDA's membership or of the relevant Working Groups in their entirety.

ISDA encouraged members to submit their own responses to this consultation.

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/961317/HMT_Safe_harbour_Consultation.pdf

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<u>**Rationale for any legal safe harbour provisions**</u>

Question 1: If a critical benchmark is designated as an Article 23A benchmark, and subject to a possible change in methodology under Article 23D, how might this create contractual uncertainty?

Question 2: Subject to responses to the previous question, would this contractual uncertainty lead to causes of action, potential liabilities or grounds for litigation, between parties to contracts or between other parties? If yes, please specify:

- **The nature of the causes of action, liabilities or grounds for litigation that could arise;**
- **How likely they would be, the circumstances and the likely timing in which these could arise;**
- **Possible impacts (quantitative and qualitative) on contractual parties and the wider market.**

While it is difficult to make generalised comments about the likelihood of success of any claims, the potential for counterparties to claim that they have been disadvantaged by changes to the methodology of LIBOR pursuant to Article 23D means that there is an increased likelihood that this will result in contractual uncertainty and litigious actions being initiated. Even where these claims are speculative in nature or are decided on a narrow set of facts, the cost to the industry of analysing the potential legal hazard, dealing with potential or actual claims and defending any consequent litigation, as well as the resulting disruption to the market, could be significant.

Uncertainty could arise with respect to issues such as:

- Whether a reference to the relevant benchmark in a contract includes a reference to that benchmark as amended;
- Whether a material change to a benchmark might trigger fallback provisions under contracts.

Where a party claims to have been disadvantaged as a result of a change in methodology, they may seek alteration to the terms of the contract, to avoid performance, or to terminate or void the contract (for example, on the grounds that the change in methodology has led to frustration of the contract or triggered a force majeure event).

If large numbers of parties seek to avoid performance under contracts or to terminate or void them, this has the potential to lead to significant market disruption. Similarly, if this leads to widespread litigation, there will be a significant cost to the industry in defending this litigation. Given that a common law system operates in England and Wales, the outcome of a single case

can have significant and disruptive consequences for market participants. Additionally, given that many participants that operate in England and Wales also operate under other jurisdictions, there is the added risk of inconsistent litigation results across multiple jurisdictions.

Question 3: Do you consider that a legal safe harbour is necessary in order to mitigate the impacts you have identified in response to the questions above?

For the reasons set out above, it would reduce the likelihood of such claims being made regardless of the strict legal merits of such claims.

Question 4: Should any legal safe harbour contain the features highlighted by HM Treasury's stakeholder feedback? Please set out your reasoning, with reference to the Financial Services Bill provisions.

The exercise by the FCA of its powers under the FS Bill has the potential to give rise to any or all of these consequences. There are no other features which we have identified that should be considered. Where appropriate given the differences between tough legacy solutions in different jurisdictions and differences between their respective legal regimes, it would be helpful if there was consistency with the features of the safe harbours being developed or contemplated in other global jurisdictions (such as the United States).

Question 5: Are there any circumstances in which we should explicitly exclude the application of a legal safe harbour and if so, why?

As a general principle, the legal safe harbour should have in scope all contracts between any counterparties that might otherwise suffer contractual uncertainty as a result of the FCA's powers being exercised under Article 23D. Therefore, in order to avoid contractual uncertainty, any contract impacted by or otherwise subject to the exercise of the FCA's powers under the Financial Services Bill should benefit from any safe harbour. We have not identified any circumstance in which application of the safe harbour should be explicitly excluded.

Question 6: Should a legal safe harbour only be required for contracts entered into before a benchmark is designated under Article 23A and therefore any contracts entered into after an Article 23A designation should not be in scope of safe harbour?

As mentioned above, the safe harbour should have in scope all contracts between any counterparties that might otherwise suffer contractual uncertainty as a result of the FCA's powers being exercised under Article 23D. While we would expect the main impact to be on contracts entered into before a benchmark is designated under Article 23A, there is also potential for contracts entered into after this date to be affected. In particular:

- The majority of the potential impacts for contracts identified above will arise upon the exercise of the FCA's powers under Article 23D, rather than immediately upon

designation of a benchmark under Article 23A. While we understand that the FCA is likely to exercise its powers under Article 23D within a reasonable period after designating a benchmark under Article 23A, we also understand that these two events would not be simultaneous. As a result, if any safe harbour is only available to contracts entered into before a benchmark is designated under Article 23A, this is likely to leave unprotected any contracts entered into after that date but before the effective date of any changes to a benchmark following on from the FCA's exercise of its powers under Article 23D

- Many contracts are negotiated over an extended period of time. If any safe harbour is available only for contracts entered into as at a specific date, this may create uncertainty for contracts which are being negotiated over the relevant period and which may end up being executed on the cut-off date or shortly thereafter.
- There is likely to be an ongoing need for contracts to be novated or subject to compression exercises in order to promote transition off the Article 23A Benchmark. Those processes would benefit from remaining in scope of any applicable safe harbour.

If any safe harbour is available only for contracts entered into before a benchmark is designated under Article 23A, it will be necessary to carry out a fuller investigation into the potential consequences in order to confirm that there are no unintended consequences.

Question 7: Should any legal safe harbour apply to third parties such as facility agents, trustees or parties to contracts ancillary/ collateral to the main contract that reference or rely upon an Article 23A benchmark? If so, how?

Yes, we consider that any legal safe harbour should apply to third parties or parties to contracts ancillary or collateral to the main contract. These persons may not have any control over whether or how they use the amended benchmark and so may otherwise be at risk of litigious claims simply by continuing to perform their role under the contract in accordance with the amended terms.

<u>Scope of any legal safe harbour</u>

Question 8: Do you have any comments on the jurisdictional issues set out above, or on the proposed approach? In particular, can respondents provide any evidence of the volumes of LIBOR referencing contracts where the law of Scotland or Northern Ireland is the choice of law, that may benefit from safe harbour provisions?

We do not have any comments on the jurisdictional issues described in Chapter 3 of the Consultation. The broad application of any safe harbour would ensure it was available in relation to any English law governed contract affected by these proposals.

The ISDA template documentation suite does not include documents governed by the law of Scotland or Northern Ireland, so we are unable to comment on the volumes of LIBOR referencing contracts that may benefit from safe harbour provisions.

Question 9: Should the scope of any legal safe harbour go beyond supervised entities making "use" of an Article 23A benchmark in specified "financial contracts", "financial instruments", and "investment funds" as defined in the BMR?

As mentioned above, the safe harbour should have in scope all contracts between any counterparties that might otherwise suffer contractual uncertainty as a result of the FCA’s powers being exercised under Article 23D. While we appreciate that the ability of HM Treasury to legislate for a safe harbour is subject to jurisdictional limits, we do not consider that availability of any safe harbour should be limited by the jurisdiction in which the parties are established or to certain counterparty types or certain product types.

A wide range of products (including derivatives) and counterparty types and counterparties established globally who have executed transactions governed by English law will be affected by any exercise of the FCA's power to amend the methodology of LIBOR. This is not limited to counterparties and products that fall within the BMR. Restricting availability of any safe harbour in this way creates the potential for an unlevel playing field between affected counterparties and products, fragmentation of markets, as well as the potential for unintended consequences (e.g., where only some parties to a product benefit from the safe harbour or where only some parts of a complex transaction structure benefit).

In addition, there remains significant uncertainty around the precise scope of which counterparties and products fall within the BMR and when a person may be considered to "use" a benchmark for those purposes. If any safe harbour is based on the scope of the BMR, these issues of uncertainty are likely to arise in connection with interpretation of the scope of the safe harbour, potentially undermining its usefulness.

Question 10: Should a legal safe harbour provide for situations where a contract describes the benchmark alongside, or instead of, the express name of the benchmark in question? If so, how? Please provide examples of contract wording to illustrate your response.

A legal safe harbour should apply in all situations where a contract references a benchmark in a way that would be affected by the exercise of the FCA's powers under Article 23D.

The template ISDA definitions that are currently used in ISDA master agreements reference the express name of the benchmark in question and identify the screen page on which the rate can be found. For example, the definition for GBP-LIBOR-BBA set out in Supplement 70 to the 2006 ISDA Definitions is "*Sterling LIBOR for a period of the Designated Maturity which appears on the Reuters Screen LIBOR01 Page at 11:55 a.m., London time (which reflects publication as of 11:00am London time) […]*".

However, we are aware that there may be collateral agreements, legacy agreements or agreements for products other than derivatives that reference screen rates that no longer exist or that describe the rate rather than using the term "LIBOR". To the extent that these

agreements would be affected by the exercise of the FCA's powers under Article 23D, we consider that any safe harbour should also apply to these agreements.

Question 11: How would we best ensure, within any legal safe harbour provisions, that parties to contracts falling in scope of the safe harbour retain the freedom to move away from referencing or relying upon a benchmark that has been designated as an Article 23A benchmark to alternative appropriate arrangements, or to terminate the contract, provided they reach consensual agreement?

In particular, how should safe harbour provisions interact with contractual fallbacks? Please provide examples of contractual wording where relevant.

We understand that any legal safe harbour would provide protection for market participants and administrators from claims or litigation arising from interpreting their contracts in line with the FCA's exercise of its powers under the Financial Services Bill. Further it would provide certainty that references to a critical benchmark should continue to be read as such following the exercise of such powers by the FCA. It would be important to ensure that the safe harbour does not override contractual fallback provisions where the parties have expressly contemplated the event in question and in doing so have specifically provided for an alternative fallback to apply (such as the ISDA IBOR fallbacks supplement/protocol).

<u>Legal immunity for the administrator of a critical benchmark</u>

Question 13: Subject to the possibility of claims arising (as above), would it be appropriate to provide for legal protection for the administrator against specific legal claims or causes of action or liabilities? If so, how should these inform the design of any legal protections for the administrator?

In your answer, please consider HM Treasury's position (as stated above) that any legal protections from litigation would apply when an administrator is acting under the direction of the FCA following the exercise of their powers in the BMR as amended by the Financial Services Bill and would not apply otherwise.

For similar reasons to those set out in our response to Questions 1 and 2 above, if uncertainty or financial loss arising from exercise of the FCA's powers leads to litigation against a benchmark administrator, this could in turn lead to market disruption as well as requiring the administrator to expend resources in responding to claims and defending itself against litigation, all of which would detract from the aim of the proposed FCA powers, which is ensuring a smooth transition away from LIBOR (or any similarly affected benchmarks).

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 74 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.