Market Trends 2017/18: Medium-Term Note Programs

A Lexis Practice Advisor® Practice Note by
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OVERVIEW

Financial service companies, such as bank holding companies, continued to use medium-term note programs as their vehicles for issuing large, underwritten offerings of notes as well as structured notes in 2017. Two significant changes occurred in 2017: the use of finance subsidiaries as issuers for structured notes, sometimes with a guarantee from the parent bank holding company, and a move to update the London Interbank Offered Rate (LIBOR) fallbacks disclosure (as further discussed below) in response to the potential cessation of LIBOR in 2021. For additional information on medium-term note programs, see Medium-Term Note (MTN) Programs.

DEAL STRUCTURE AND PROCESS

Medium-term note programs (MTN programs) are designed to allow fast market access by frequent issuers without the burden of negotiating a suite of takedown documents for each issuance. At the launch of an MTN program, a set of deal documents are negotiated and executed: a distribution agreement (designed for continuous offerings, as opposed to an underwriting agreement negotiated for a specific offering), the issuer's existing debt indenture, and ancillary documents, such as a calculation agency agreement and an exchange rate agency agreement.

The offering documents for an MTN program will be a base prospectus with a general description of the issuer's debt securities that may be issued under the indenture, a more detailed prospectus supplement describing the notes to be issued under the MTN program, and free writing prospectuses and/or pricing supplements, each of which will include the specific details of each offering. The prospectus supplement will usually include a description of the issuer's fixed and floating rate notes, and the various underlying rates for floating rate notes (e.g., LIBOR, the Constant Maturity Swap Rate (CMS), the Euro Interbank Offered Rate (EURIBOR), the Federal Funds rate, and others). For further information, see Takedowns under a Medium-Term Note (MTN) Program.

Frequent issuers of structured notes may also have so-called product supplements that will describe particular products or structures. For example, an issuer may have a product supplement designed to work with its MTN program that will describe various features of structured notes linked to indices or exchange-traded funds. Some issuers will have product supplements that just contain descriptions of a number of indices or exchange-traded funds (ETFs). The use of product supplements allows the free writing prospectus or pricing supplement for a particular deal to be shorter, because much of the basic information about the note is contained in the product supplement, as is the full description of the underlying index or ETF.

The issuer will usually have multiple agents execute the distribution agreement. The agents may act in the role of principal (i.e., underwriter/dealer) or as an agent for the issuer for direct sales by the issuer to the investor. Under the distribution agreement, the agents are entitled to receive diligence documentation from the issuer on a regular basis—usually quarterly, coincidental with the issuer's filing of its Form 10-K or 10-Q. The diligence documentation will consist of a comfort letter, officers' certificate of the issuer, and counsel's Rule 10b-5 letter confirming that the prospectus (which includes the issuer's filings under the Securities Exchange Act of 1934 incorporated by reference therein) do not make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. For further information on registered MTN programs, see Establishing a Registered Medium-Term Note Program Checklist, Conducting Takedowns Under a Registered Medium-Term Note Program Checklist, and Updating a Registered Medium-Term Note Program Checklist.

Often the underwriter is an affiliated broker-dealer of the issuer. In that case, the MTN program must be rated investment grade by a rating agency, or the issuer's debt of the same class must be so rated. Having that rating will perfect an exemption from filing with the Financial Industry Regulatory Authority, Inc.

Some MTN programs are set up with only one agent signed up to the distribution agreement, which may be the issuer's affiliated broker-dealer. That broker-dealer will then, in turn, execute dealer agreements with other distributors. In that situation, when the structured notes are issued, they are sold first to the affiliated broker-dealer and then to an unaffiliated distributor.

At the time of a structured notes offering, the agent, acting as an underwriter, will agree on the terms of the offering with the issuer, whether through a form terms agreement or a more informal process (such as an e-mail or other confirmation). Issuer's counsel usually prepares the preliminary offering document, which will be either a free writing prospectus or preliminary pricing supplement. That document is then filed with the Securities and Exchange Commission (under Rule 433 (17 C.F.R. § 230.433) for free writing prospectuses or Rule 424(b)(2) (17 C.F.R. § 230.434) for preliminary pricing supplements), and the underwriter will then proceed to market the notes. For many structured notes issuers that operate on a repeating "calendar" basis, the preliminary offering documents are filed early in the month and the offerings generally price and close about three weeks later. For more information on free writing prospectuses, see Free Writing Prospectus Checklist, Using a Free Writing Prospectus Flowchart, and Timing for Filing a Free Writing Prospectus Checklist.

DEAL TERMS

Response to TLAC and Eligible Long-Term Debt Requirements

On December 15, 2016, the Board of Governors of the Federal Reserve System issued its final rules regarding total loss absorbing capacity (TLAC) and the amount of unsecured long-term debt (LTD) required to be maintained by a bank holding company (BHC). Because the TLAC requirements apply to BHCs but not to a BHC's subsidiary, many BHC issuers of structured notes moved their MTN programs to a subsidiary. In some cases, the structured notes issued by those subsidiaries are guaranteed by the BHC.

In order to qualify as eligible LTD, the governing indenture of a BHC cannot give holders the right of acceleration for principal or interest, except upon an insolvency, or a payment default after a 30-day grace period. Typical defaults (such as covenant defaults, cross-defaults, and sinking fund non-payments) are no longer acceptable as events of default in the BHC's indenture.

Consequently, in 2017, a number of BHC issuers of structured notes supplemented their indentures in the following manner:

- Sinking fund deposit and covenant defaults were removed.
- Covenant Breach was added:
  - Breach of any covenant in the indenture (including the deposit of any sinking fund payment) was not an event of default.
  - But holders can sue on the contract.
  - Damages are uncertain (as opposed to acceleration upon an event of default).
- The merger clause was clarified to state that all events of default and covenant breaches must be resolved prior to a merger, plus any default (defined to include any event that, after notice or lapse of time, would become an event of default or a covenant breach) must be resolved.
- Generally, disallowed events of default were put into the covenant breach category.
- Holders seeking to enforce a covenant breach must satisfy the notice and indemnity provisions of the limitations on suits requirements.

These changes would be applicable to the structured notes of a BHC and also to the guarantee by a BHC of the structured notes of its subsidiary issuer.

DISCLOSURE TRENDS

Revisions to the LIBOR fallbacks

In response to various investigations into LIBOR, frequent issuers of floating rate notes and structured notes linked to LIBOR already had expanded their risk factors, generally to disclose that the future of LIBOR was uncertain and that historical graphs looking back at LIBOR levels over the years may have reflected distorted rates. For more information on the LIBOR investigations, see Wheatley Review of LIBOR.

In July 2017, the UK Financial Conduct Authority announced that the LIBOR rate would be phased out after 2021. This announcement prompted issuers to focus on how they would update their LIBOR fallbacks for notes that, once issued, would mature after 2021.

The current LIBOR mechanism included in floating rate notes, including fixed to floating rate notes issued under an MTN program, provides that if LIBOR is not published on the appropriate Reuters screen page, then, under the first fallback provision, the calculation agent will, in the case of U.S. dollar LIBOR, poll banks in the London interbank market for rates for deposits of the same tenor and currency. If that poll fails to produce at least two quotations, then, under the second fallback provision, the calculation agent would poll major banks in New York City for quotes for loans of the same tenor and the same currency offered to leading European banks. If the second poll fails to produce at least two quotations, then, under the final fallback provision, LIBOR will remain the same as in the previous interest period.

As one might imagine, if LIBOR hasn't been published in the normal manner, it is highly unlikely that a rate-submitting bank would provide a quote to a calculation agent calling up on the phone. The end result of the failure of the polls and the application of the final fallback mechanism would be that a floating rate note would become a fixed rate note.

It has been reported that, without taking any action to address the current LIBOR fallbacks, approximately $68.51 billion of investment grade floating rate debt and $55.68 billion of U.S. bank TLAC debt would become fixed rate debt after LIBOR ceases publication.

Determining if LIBOR has ceased

Although it may be obvious at the time, in some cases issuers are beginning to define what exactly will constitute a LIBOR cessation. Precision in this area will protect issuers from claims by note holders that a viable LIBOR rate was ignored, to their detriment. One set of guidelines provides that any one of the following will generally constitute a LIBOR cessation:

- The insolvency of the relevant interbank offered rate (IBOR) administrator (and there is no successor administrator);
- A public statement by the relevant IBOR administrator that it will cease publishing the relevant IBOR permanently or indefinitely (and there is no successor administrator that will continue publication of the relevant IBOR)
- A public statement by the supervisor for the relevant IBOR administrator that the relevant IBOR has been permanently or indefinitely discontinued
- A statement by the supervisor for the relevant IBOR administrator that the relevant IBOR may no longer be used

These termination events would apply to all of the interbank offered rates, not just LIBOR (e.g., the Tokyo Interbank Offered Rate (TIBOR) and EURIBOR). One proposed variation on these termination events adds a “no revocation” condition to the last three bullet points above. Another variation allows for a notice by the calculation agent to the issuer and the note holders that LIBOR has been discontinued.

Which replacement rate?

Market participants expect that the new base rate for floating rate notes will be the Secured Overnight Financing Rate (SOFR). Because SOFR is a secured, backward-looking overnight financing rate and LIBOR is a forward-looking, unsecured rate with various tenors, the market also expects an adjustment to SOFR in the form of a risk spread and a forward-looking term structure quoted by the Federal Reserve Bank of New York (FRBNY) or another entity designated by the Alternative Rates Reference Committee (ARRC) or the International Swaps and Derivatives Association, Inc. In response to calls from regulators to identify a “risk-free” U.S. Dollar LIBOR replacement, the ARRC selected, on June 22, 2017, SOFR as an alternative to U.S. Dollar LIBOR.

The FRBNY began publishing SOFR on April 3, 2018. On April 16, 2018, the FRBNY announced that it had “mistakenly included certain repo transactions in the settings for April 2 to April 12 ….” Almost the first two weeks of SOFR publication were erroneous.

One concern is that the risk spread and forward-looking term structure required to adjust SOFR to LIBOR has not yet been calculated, although SOFR has been known to market participants for at least one year. Without this adjustment, issuers and calculation agents will be scrambling for a LIBOR replacement in 2021. According to the ARRC, the adjustment won’t be ready until 2021 – uncomfortably close to the anticipated LIBOR cessation. Perhaps as SOFR is used more and establishes liquidity, then the adjustment will become clearer.

Who picks the LIBOR replacement?

The updated LIBOR fallback disclosures contemplate the calculation agent choosing a LIBOR substitute, with appropriate adjustments (including a spread), once LIBOR ceases. Some disclosures refer to this rate as one that is generally accepted in the industry, while others have a more precise requirement (e.g., “the alternative reference rate selected by the central bank, reserve bank, monetary authority or any similar institution (including any committee or working group thereof) that is consistent with accepted market practice”). Where the calculation agent is an affiliate of a financial institution (such as a BHC), there seems to be less concern about calculation agent liability for its choice of a successor rate. In some examples in which the calculation agent is an unaffiliated third party and the issuer is not a financial institution, in the event that a substitute for LIBOR will be required, the issuer would appoint an independent financial institution to decide whether the substitute is generally accepted by the industry.

Adjustments to the new rate

Most updated LIBOR fallback disclosures contemplate that the calculation agent may have to adjust the business day convention, interest determination dates, day count conventions, and other terms of the LIBOR floating rate note for the replacement rate. One disclosure contemplates the calculation agent adjusting the risk spread between the replacement rate and LIBOR. In some cases, there is a requirement that the calculation agent consult with the issuer before making any of these adjustments.

What if there is no agreed upon replacement rate?

What happens if, in the last analysis, there is no agreement on a replacement rate for LIBOR? Some alternatives have total calculation agent discretion for choosing a substitute or successor base rate that is most comparable to LIBOR. Another choice is to have the issuer appoint an investment bank of national standing in the United States (including an affiliate of the issuer) to determine an appropriate alternative rate.

Risk factors

The uncertainty with respect to the timing of a LIBOR replacement and the current absence of an adjustment for SOFR calls out for clear risk factor disclosure. Risk factors have been, and should be, updated to reflect the uncertainty and to highlight the potential conflicts of interest between the calculation agent, which may be an affiliate of the issuer, and the note holders if the calculation agent has to pick a replacement rate in an environment where there is no agreement in the market on a LIBOR replacement. For more information on risk factors, see Market Trends 2016/17: Risk Factors, Top 10 Practice Tips: Risk Factors, and Risk Factor Drafting for a Registration Statement.

What about outstanding LIBOR floating rate notes that mature after 2021?

None of these improved disclosures will apply to existing LIBOR floating rate notes that mature past 2021—at least, without a consent solicitation. Generally, a debt indenture requires 100% consent of the note holders to change the interest rate, a costly and difficult exercise.

MARKET OUTLOOK

In 2018, issuers are expected to continue to update their LIBOR fallback disclosures and the related risk factors. Market participants will be carefully watching SOFR and how the financial industry works on creating the risk spread and forward-looking term structure adjustment between SOFR and LIBOR. As SOFR-linked debt instruments pick up traction in the market and issuers see progress on the risk spread and forward-looking term structure, issuers will have less concerns about replacing LIBOR in their structured notes and other floating rate debt instruments.

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Bradley Berman is counsel in Mayer Brown's New York office and a member of the Corporate & Securities practice. He represents domestic and non-US issuers on domestic and international securities offerings of structured products linked to equities, commodities, interest rates, currencies and other underlying assets. Bradley has extensive experience with exchange-traded notes. He advised Royal Bank of Canada and RBC Capital Markets LLC on the first exchange-traded note issued by a Canadian issuer into the United States and has since advised Royal Bank of Canada and another Canadian issuer on multiple exchange-traded notes. He also represented a non-US frequent issuer on all of their exchange-traded notes for three years. Bradley also has expertise in advising issuers and dealers on the creation of proprietary indices. Bradley advises issuers on shelf registration statements and medium term note programs and issuances exempt from registration under Regulation S, Rule 144A or Section 3(a)(2). He has worked on many bank note issuances by state and national banks. Bradley also advises broker-dealers on the FINRA communication rules and suitability issues. His work previously involved capital-raising debt and equity transactions for large bank holding companies, including several common stock issuances. He has extensive experience with negotiating underwriting, distribution and dealer agreements and related deal documents, including indentures.

Recently, Bradley advised an issuer on establishing a registered structured warrant program, including post-effectively amending their registration statement to add a new class of warrants and drafting the issuer's first warrant indenture.

Bradley is co-author of *Considerations for Foreign Banks Financing in the United States* (2012; updated 2014, 2016), published by International Financial Law Review.

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