Market Trends 2018/19: Medium-Term Note Programs

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This market trends article examines recent trends regarding medium-term note programs (MTN programs), providing an overview of the market in 2018 and 2019 with a focus on general deal structure and process, recent deal terms, and disclosure trends. 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 2018. Two significant changes occurred in 2018 and early 2019: the addition of new provisions to underwriting, distribution, and dealer agreements in order to comply with the QFC Stay Rules applicable to U.S. global systemically important banking organizations (GSIBs), as further described below, and the finalization of new fallback language to be added in new issues of floating rate notes with U.S. dollar LIBOR (USD LIBOR) as a base rate, in anticipation of 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

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 include 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). As discussed below, because the secured overnight financing rate (SOFR) will be the replacement rate for USD LIBOR, some issuers are including a description of SOFR and related risk factors in their prospectus supplement. For further information, see Medium-Term Note (MTN) Program Takedowns.

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 makes it possible to shorten the free writing prospectus or pricing supplement for a particular deal, 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 MTN 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, coinciding 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 Registered Medium-Term Note Program Establishment Checklist, Registered Medium-Term Note Program Takedown Checklist, and Registered Medium-Term Note Program Update 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 the requirement to use a qualified independent underwriter under the rules of 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 notes are issued, they are sold first to the affiliated broker-dealer and then to an unaffiliated distributor.

At the time of a note 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 email or other confirmation). Issuer's counsel usually prepares the preliminary offering document, which will be either a free writing prospectus or a 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

Application of the QFC Stay Rules to Securities Contracts

Beginning on January 1, 2019, U.S. GSIBs and their subsidiaries began including new provisions in their securities contracts under the QFC Stay Rules. The QFC Stay Rules require Covered Entities to include standardized contractual stay language in certain of their qualified financial contracts (QFCs) in order to mitigate the risk of destabilizing closeouts of Covered Entities' QFCs, which could be an impediment to an orderly resolution. Only Covered Entities are subject to the QFC Stay Rules. Covered Entities includes U.S. GSIBs and their subsidiaries worldwide, as well as the U.S. subsidiaries, U.S. branches, and U.S. agencies of non-U.S. GSIBs. If an underwriting, distribution, or dealer agreement qualifies as an in-scope QFC, then it needs to include the new standardized language. An in-scope QFC meets the following conditions:

- The contract is a QFC –and–
- The contract explicitly either
  - Provides one or more default rights that may be exercised against a Covered Entity –or–
  - Includes a transfer restriction that restricts the transfer of the contract or any interest in or obligation in or under, or any property securing, the contract

Any underwriter, dealer, or distributor who enters into a securities contract with, for example, a bank, bank holding company, or affiliated dealer of such entity will have to ensure that the QFC Stay Rule provisions are included in that contract. A securities contract is defined to include a contract for the purchase, sale or loan of a security, or option on a security. A default right is defined very broadly and includes a right of a party under an agreement to liquidate, terminate, cancel, rescind, or accelerate an agreement or transactions thereunder, set off or net amounts owed, demand payment or delivery, or suspend, delay or defer payment, or performance thereunder. A defaulting underwriter provision in an underwriting agreement, for example, may be considered a default right under the QFC Stay Rules.

Transfer restriction broadly refers to any provision that limits the ability of one party to assign its rights or obligations under the agreement (whether by prohibiting all such assignment or allowing the party to assign the agreement only to certain types of entities or only subject to certain conditions) or provides that assignments are subject to the other party's consent. This is a common provision in underwriting, distribution, and dealer agreements.

In-scope QFCs entered into after January 1, 2019, must be conformed to the QFC Stay Rules requirements no later than July 1, 2019, where all parties other than the Covered Entities are financial counterparties.

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 would mature after 2021.

LIBOR Fallback Provisions for Non-U.S. Dollar Floating Rate Notes

The current LIBOR mechanism included in many existing 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 poll banks in the London interbank market for rates for deposits of the same tenor and index 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 the relevant financial center for the index currency for quotes for loans of the same tenor and the same index 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. 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.

This disclosure is from the 2006 International Swaps and Derivatives Association, Inc. (ISDA) definitions (the 2006 ISDA Definitions), and is still valid for non-U.S. dollar LIBOR floating rate notes until the relevant governmental body for such non-U.S. dollar index currency publishes updated fallback provisions for LIBOR floating rate notes linked to that index currency. There is currently some flux in the market regarding using these provisions for non-U.S. dollar LIBOR disclosure. U.S. issuers tend to keep this disclosure, while non-U.S. issuers generally are moving to EU benchmark replacement provisions for non-U.S. dollar LIBOR fallbacks. This disclosure should no longer be used for USD LIBOR floating rate notes.

LIBOR Fallback Provisions for USD LIBOR Floating Rate Notes

For floating rate notes linked to USD LIBOR, new final fallback provisions applicable to newly issued floating rate notes were published by the Alternative Reference Rates Committee (ARRC) on April 25, 2019 (the ARRC Recommendations). These provisions replace the old USD LIBOR fallback provisions described above.

Determining If LIBOR Has Ceased

There are three Benchmark Transition Events, the occurrence of any of which will trigger a move from LIBOR to the replacement rate.

The first two Benchmark Transition Events are triggered on a permanent cessation of LIBOR. These two triggers require that the LIBOR administrator (currently ICE Benchmark Administration), the LIBOR regulatory supervisor of the LIBOR administrator (currently the UK Financial Conduct Authority), the U.S. Federal Reserve System (as the central bank for the currency of USD LIBOR), or a bankruptcy/resolution official or court with jurisdiction over the administration of LIBOR publicly state or publicize information that LIBOR has actually ceased or is expected to cease. These Benchmark Transition Events will not trigger a change from LIBOR until the date that LIBOR ceases to be published, if that date is later than the date of the relevant announcement. In contrast, for the pre-cessation trigger described below, the change from LIBOR would begin on the date of the announcement or publication.

The ARRC Recommendations also added a pre-cessation trigger predicated on a public statement or publication of information by the regulatory supervisor for the administrator of the Benchmark announcing that the Benchmark is no longer representative.

Benchmark Replacement Waterfall

The ARRC Recommendations also finalized the order of replacement rates for USD LIBOR floating rate notes in a Benchmark Replacement Waterfall:

- Step 1: Term SOFR + Adjustment
- Step 2: Compounded SOFR + Adjustment
- Step 3: Relevant Governmental Body Selected Rate + Adjustment
- Step 4: ISDA Fallback Rate + Adjustment
- Step 5: Issuer or its Designee Selected Rate + Adjustment

However, an issuer may not move down the Benchmark Replacement Waterfall in the event that some USD LIBOR tenors have become subject to a Benchmark Transition Event but both shorter and longer tenors are available. For example, if three-month USD LIBOR has ceased publication but one-month and six-month USD LIBOR are still being published, the issuer would use an Interpolated Benchmark (i.e., interpolated USD LIBOR) before proceeding to the Benchmark Replacement Waterfall.

Term SOFR + Adjustment. This would be a forward-looking term rate with a tenor matching the USD LIBOR tenor selected or recommended by the Relevant Governmental Body (the ARRC for USD LIBOR). It is not expected that Term SOFR that is IOSCO-compliant and based on a broad derivatives market will be available prior to the expected LIBOR cessation. Also, because ISDA is not expected to reference a forward-looking term rate, the use of this rate in floating rate notes may cause a hedging mismatch. Consequently, the ARRC confirms that issuers may wish to delete Term SOFR from the Benchmark Replacement Waterfall and adjust other terms accordingly.

Compounded SOFR + Adjustment. Compounded SOFR is a method to create an interest rate for a period by using a compounded average of the daily SOFR rates during the interest period. The interest calculation is done in arrears (i.e., at the end of the interest period). The definition of Compounded SOFR specifically allows for a lookback or suspension period and flexibility for change in the future due to direction from the ARRC or market-accepted conventions. The ARRC Recommendations also allow users to use a simple average of SOFR, rather than Compounded SOFR, plus an adjustment, if desired.

Compounded SOFR requires a lookback or suspension period because SOFR is a daily backward-looking rate, and the rate announced each day is actually the rate that was used the previous day. The plumbing issue here is that a normal floating rate note interest period begins on the settlement date or the previous interest payment date, and interest accrues from that date to but excluding the next interest payment date or the maturity date, as applicable. If an interest payment date falls on a Friday, the rate announced on that Friday would be Thursday's rate, allowing the interest rate to be calculated on Friday but with no advance notice to holders and insufficient time to ensure that the paying agent can receive funds from the issuer and then pay the interest payment to holders on that day.

Using a suspension or lockout method solves for this, where the daily SOFR rate would lock in a certain number of business days before the last day of the interest period. For example, if the interest payment date was Friday, with interest accruing through Thursday, and a four-business day lockout period was in effect, the SOFR rate for the Friday before the interest payment date, which would be published on the Monday prior to the interest payment date, would hold to and including Thursday. Consequently, on Monday morning, the issuer, paying agent and the holders would have advance notice of the interest payment to be made on Friday. Similar results can be reached with a lookback or lag period, under which each day's SOFR rate is the rate for a specified number of business days prior to that day.

Relevant Governmental Body Selected Rate + Adjustment. This choice is designed to address a situation in which an SOFR-based rate has been discontinued and the ARRC or other similar governmental committee selects or recommends a replacement rate.

ISDA Fallback Rate + Adjustment. Failing steps one through three, an issuer would look to the fallback rate used by ISDA in the 2006 ISDA Definitions in effect at the time of the LIBOR cessation. The current ISDA Fallback Rate, included in USD-SOFR-COMPOUND and published in ISDA Supplement No. 57, is a sequence that first looks to the ARRC's recommended replacement for SOFR, next the Overnight Bank Funding Rate published by the Federal Reserve Bank of New York, then the FOMC Target Rate published by the Board of Governors of the Federal Reserve System.

Issuer or its Designee Selected Rate + Adjustment. This final step allows an issuer or its designee to choose a replacement rate for the corresponding USD LIBOR tenor that "gives due consideration to any industry-accepted rate of interest as a replacement for the then-current Benchmark for U.S. dollar denominated floating rate notes at such time . . . "

Benchmark Adjustment Waterfall

Because SOFR is backward-looking, secured, has no tenors and does not reflect credit risk, as does LIBOR, which is an unsecured forward-looking rate, there will have to be an adjustment to the Benchmark Replacement to compensate for the differences. These adjustments may be positive, negative, or zero.

ARRC Selected Adjustment. This adjustment is designed to be used with Term SOFR to correlate with the related USD LIBOR tenor. Because the ARRC acknowledges that market participants may want to skip Term SOFR as a Benchmark Replacement, going straight to Compounded SOFR to achieve greater alignment with derivatives, in doing so issuers should also remove the ARRC Selected Adjustment from their documentation.

ISDA Fallback Adjustment. This adjustment is designed to be used only if the Benchmark Replacement is the ISDA Fallback Rate. The ARRC Recommendations note that ISDA has not analyzed, and will not analyze, whether its fallbacks, including any spread adjustments, are appropriate in a nonderivative context.

Issuer or Its Designee Selected Adjustment. Much like the Issuer or Designee Selected Benchmark Replacement, this Adjustment allows an issuer or its designee to choose an adjustment that gives due consideration to any industry-accepted spread adjustment, or method for calculating or determining such spread adjustment, for the replacement of the then-current Benchmark with the applicable Benchmark Replacement for U.S. dollar denominated floating rate notes at such time.

The method of calculation of the first two Benchmark Replacement Adjustments has yet to be determined.

When updating an MTN program that includes USD LIBOR floating rate notes, the ARRC Recommendations should be consulted for additional relevant terms to be included.

Other 2018 Developments

In late 2018, qualifying Canadian bank issuers adopted bail-in provisions in their MTN programs and other debt offering documents. These provisions came into effect on September 23, 2018 and applied to the debt issuances of Canadian banks that are D-SIBs (domestic systemically important banking organizations). Under the bail-in provisions, in the event that an issuing D-SIB went into resolution, among other things, their debt securities could be converted into common shares of the D-SIB or an affiliate.

Green bond issuances, generally issued under MTN programs, continued to increase in 2018.

Risk Factors

The uncertainty with respect to the timing of Term SOFR as a USD LIBOR replacement and the potential differences between the USD LIBOR rate for any particular tenor and the Benchmark Replacement rate and Benchmark Adjustment call out for clear risk factor disclosure. Risk factors have been, and should be, updated to reflect this 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. Issuers are also adding risk factors relating to SOFR to their MTN programs. 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 2019, issuers will continue to update their LIBOR fallback disclosures and the related risk factors. With the publication of the ARRC Recommendations, issuers will move away from the old 2006 ISDA Definitions-based LIBOR fallbacks for USD LIBOR and adopt the new fallbacks. Market participants will also be carefully watching the SOFR market and when Term SOFR will appear. As SOFR-linked debt instruments pick up traction in the market, issuers will have fewer concerns about replacing USD LIBOR in their structured notes and other floating rate debt instruments.

Most MTN programs with issuers that are GSIBs or affiliates of non-U.S. GSIBs have already updated their distribution and dealer agreements to incorporate the QFC Stay Rules provisions.

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Bradley Berman is of counsel in the Capital Markets group at Morrison & Foerster LLP, New York. He advises domestic and non-U.S. issuers on domestic and international securities offerings of structured products linked to equities, commodities and currencies. Previously, his work involved capital-raising debt and equity transactions for large bank holding companies, including several common stock issuances.

Bradley has extensive experience with exchange traded notes and advised a non-U.S. frequent issuer on all of its exchange traded notes over the last three years. He also advises issuers and underwriters on shelf registration statements, medium term note programs and exempt transactions, and has worked on many bank note issuances by state and national banks.

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