

Market Trends 2019/20: Medium-Term Note Programs

A Lexis Practice Advisor® Practice Note by Bradley Berman, Mayer Brown LLP



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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 2019 and 2020 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 2019. A significant change occurred in 2019 and early 2020: the addition of new provisions adding the secured overnight financing rate (SOFR) as a new base rate for issues of floating rate notes, in anticipation of the replacement of U.S. dollar LIBOR.

For additional information on medium-term note programs, see [Medium-Term Note \(MTN\) Programs](#) and [Top 10 Practice Tips: Medium-Term Notes](#).

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 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. During 2019 and into 2020, issuances of USD LIBOR floating rate notes became rarer, even though issuers continue to include provisions for USD LIBOR and LIBOR based on other currencies in their MTN program documents. 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 Flowchart](#), [Registered Medium-Term Note Program Establishment Checklist](#), [Registered Medium-Term Note Program Takedown Flowchart](#), [Registered Medium-Term Note Program Takedown Checklist](#), [Registered Medium-Term Note Program Update Flowchart](#), 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](#) and [Free Writing Prospectus Flowchart](#).

Disclosure Trends

In 2019 and into early 2020, the market has been characterized by more issuances of shorter-term notes, more issuances of fixed rate, rather than floating rate, notes, and some fixed-to-floating rate notes with SOFR for the floating rate leg. Issuers increased their issuances of green bonds from their MTN programs. Late March and early April 2020 saw an extraordinary volume of issuances of investment grade debt by issuers that could access the markets. These issuances provided additional liquidity to withstand the economic downturn caused by the COVID-19 lockdown.

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.

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, or “legacy,” 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 should no longer be used for USD LIBOR floating rate notes. Instead, if an issuer is going to include LIBOR in its MTN program, the ARRC-recommended fallback provisions described below should be used for USD LIBOR and the EU benchmark replacement provisions should be used for non-USD LIBOR fallbacks.

LIBOR Fallback Provisions for USD LIBOR Floating Rate Notes

For floating rate notes linked to USD LIBOR, 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. The current expectation is that Term SOFR will be available in the first half of 2021. 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.

As hinted at in the ARRC Recommendations, with respect to SOFR floating rate notes using compounded SOFR (rather than simple average SOFR), methods of calculating the interest payment other than using the suspension or lockout method have developed and been recommended by the ARRC (see discussion below). The suspension or lockout method has generally fallen out of favor, due to the tendency of SOFR to spike at certain times. Issuers have been concerned about locking into a spiked or abnormal SOFR rate for a certain number of business days. Consequently, when giving effect to the ARRC

Recommendations for USD LIBOR floating rate notes that fall back to Compounded SOFR, methods other than lookback or lockout may be used.

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 USD denominated floating rate notes at such time.

The method of calculation of the first two Benchmark Replacement Adjustments has yet to be finalized. Both ISDA and the ARRC have published consultations, soliciting comments from market participants, and the ARRC's consultations are designed to produce a Benchmark Replacement Adjustment that will align with the ISDA Fallback Adjustment.

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.

New SOFR Provisions

The ARRC published four sample term sheets for SOFR floating rate notes. These term sheets can be the basis of new SOFR provisions in MTN programs. The first three term sheets covered methods for using compounded SOFR in floating rate notes.

The three methods are lookback, observation period shift, and payment delay. The reason that any of the three provisions might be used by an issuer of an SOFR floating rate note goes to the nature of SOFR. SOFR is a backward-looking daily overnight rate, as opposed to LIBOR, which is a forward-looking term rate. Among other differences, issuers of USD LIBOR floating rate notes and note holders know the interest rate for any LIBOR interest period, say three months, at the beginning of the interest period. Consequently, there is certainty and advance notice as to how much interest will be paid to the holder three months hence.

Because SOFR is an overnight rate that is compounded daily during the interest period, the rate for the interest period will not be known until the interest payment date. Interest on FRNs accrues from and including the issue date or the previous interest payment date, to but excluding the following interest payment date or the maturity or redemption date, as applicable. For example, if an interest payment date for an SOFR FRN 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. The three model term sheets each detail how to alleviate this problem.

For a lookback period, the daily SOFR rate for each day in the interest period will be the daily SOFR rate for a certain number of U.S. government securities business days before the date of determination. For example, if the interest payment date was Friday, with interest accruing through Thursday, and a five U.S. government securities business day lookback was in effect, the last daily SOFR rate used for the determination of the compounded SOFR rate for the interest period would have occurred on the Thursday the week prior. Consequently, on the Friday interest payment date, the issuer, paying agent, and the holders would have had a week's advance notice of the payment to be made on the Friday interest payment date.

For the observation period shift, the interest period is shifted back a certain number of U.S. government securities business days prior to the relevant interest payment date. For example, if the interest payment date was to be on a Friday, the relevant interest period would be from and including the Wednesday prior to the previous interest payment date to but excluding the Wednesday prior to the relevant interest payment date. With a two U.S. government securities business day shift, this allows two business days' notice of the interest payment.

The final approach, payment delay, simply delays payment for two business days after the interest payment date, except at maturity or early redemption. The interest periods run from and including an interest payment date to but excluding the following interest payment date. Consequently, if an interest period ends on a Friday, holders will be paid their interest on the following Tuesday. For the final interest period prior to maturity or early redemption, a "rate cut-off date" or "lockout" is used, so that the daily SOFR rate in effect a certain number of U.S. government securities business days prior to the maturity or redemption date applies to but excluding the maturity or redemption date, as applicable. For example, with a three-U.S. government securities business day rate cut-off date in effect, if the maturity date is a Friday, the SOFR rate on Tuesday will apply from Tuesday through Thursday, and the holder will be paid on Friday.

The ARRC also published universal SOFR floating rate note fallback provisions, which put into a logical order the SOFR replacement provisions originally included in the ARRC Recommendations in the context of a USD LIBOR fallback, but tailored for an SOFR cessation.

The fourth sample term sheet shows how to use the new SOFR Index with observation period shift as a base rate. The SOFR Index is an alternative to the calculation methods in three sample term sheets discussed above. Under the methods described above, SOFR was measured each day in the interest period, compounded, and the interest rate for the period was calculated at the end of the interest period.

The SOFR Index measures SOFR, compounded since April 2, 2018, which was the first date of publication of SOFR. For an SOFR floating rate note based on the SOFR Index, to determine the interest rate for any interest period, the issuer or the calculation agent would just compare the SOFR Index levels at the start and end dates of the interest period. The interest period can be any length. The compounding is built into the SOFR Index level. Because there is no guarantee that the SOFR Index level at the end of the interest period will be higher than the SOFR Index level at the start of the interest period, the result may be an interest rate that is zero or negative. Accordingly, care should be taken to ensure that the interest rate is floored at zero.

Inclusion of the QFC Stay Rules in Securities Contracts

In 2019, qualified financial contract (QFC) provisions were added 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). The QFC Stay Rules require Covered Entities to include standardized contractual stay language in certain of their 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.

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 also have been adding risk factors relating to SOFR to their MTN programs. In late 2019 through early 2020, issuers

updated their risk factors to include the completion of Brexit. Issuers are currently adding to their base offering documents risk factors explaining the effect of COVID-19 on their businesses.

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 legacy 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.

Outstanding USD LIBOR floating rate notes issued prior to the use of any fallback provision to another reference rate (such as SOFR) (Legacy FRNs) will, without any intervention, become fixed rate notes. That is because the fallback provisions in Legacy FRNs, which follow the 2006 ISDA Definitions and involve polling banks for quotes on rates, did not contemplate a permanent LIBOR cessation. Consequently, most of these outstanding Legacy FRNs will keep resetting at the last published USD LIBOR rate, effectively converting into fixed rate notes at that last published USD LIBOR rate.

On March 6, 2020, the ARRC published its “Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition” (the NYS Proposal). The NYS Proposal governs financial contracts referencing USD LIBOR, including loans, securitizations, and floating rate notes. The NYS Proposal was submitted to the New York legislature in the spring of 2020, but the legislature adjourned without taking any action.

Market Outlook

In 2020, as SOFR-linked debt instruments pick up traction in the market, issuers will have fewer concerns about replacing USD LIBOR as a base rate in their structured notes and other floating rate debt instruments. A broad adoption of the four ARRC sample term sheets is expected as models of how to calculate interest using Compounded SOFR. As more SOFR floating rate notes are issued, it remains to be seen which of the methods of interest calculation in the four ARRC sample term sheets is adopted widely in the market.

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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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