The SEC Raises the Stakes: How the Recent Amendments to Rule 15c2-12 Will Affect Municipal Bond Issuers

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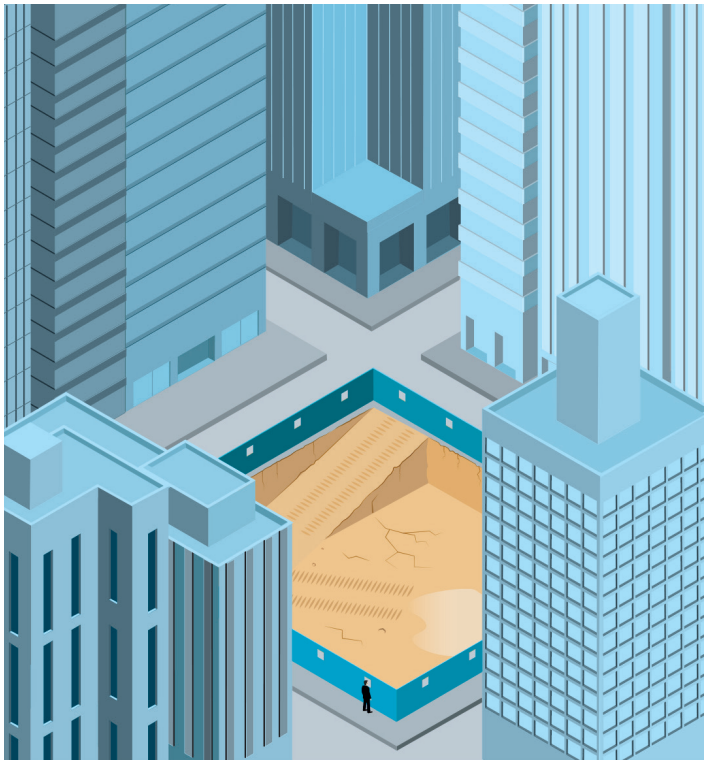

Starting early next year, municipal bond issuers and other "obligated persons"[1] will become obligated to publicly disclose certain information regarding their bank loans, municipal leases, direct purchases or private placements of bond issues, derivatives and other types of non-publicly offered financial obligations. The Securities and Exchange Commission ("SEC"), wishing to "add transparency to the municipal securities market by increasing the amount of information that is publicly disclosed about material financial obligations incurred by issuers"[2], recently adopted two amendments to Rule 15c2-12[3] (the "Rule") under the Securities Exchange Act of 1934. These amendments add two new "events" to the list of events required by the Rule to be included in continuing disclosure undertakings and posted on the Electronic Municipal Market Access ("EMMA") website of the Municipal Securities Rulemaking Board ("MSRB").[4]

The two new events added by the SEC will, by its own admission, likely result in municipal bond issuers and underwriters incurring additional time and expense[5] in order to comply with the Rule – both before and after these amendments to the Rule take effect on February 27, 2019 (the "Compliance Date"). In order to lessen the impact of the two new event disclosure requirements, issuers, underwriters, municipal advisors and others involved in public finance, including municipal attorneys representing issuers, should become familiar with the changes to the Rule well before the Compliance Date.

New Disclosure Events Added to the Rule

The Rule prohibits an underwriter from buying or selling municipal bonds unless it has reasonably determined that the issuer, or other obligated person, has agreed in a written continuing disclosure undertaking or agreement to provide specific information on EMMA.[6] The Rule currently lists fourteen specific events for which notice is to be posted on EMMA within ten business days after occurrence.[7] On August 20, 2018, the SEC announced that it is adding two new events requiring issuers and obligated persons in municipal bond offerings to agree in writing to provide notice of:

- The incurrence of a financial obligation of the obligated person, if material,[8] or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material (new "Event Numbered 15"); and
- a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties (new "Event Numbered 16").[9]

The amendments to the Rule will only affect continuing disclosure agreements entered into by an issuer or obligated person on or after the Compliance Date. An issuer's existing continuing disclosure undertakings will be unaffected by the amendments to the Rule.

It may be noted that, in primary offerings, material information must be disclosed pursuant to the antifraud provisions of the federal securities laws[10] and, as applicable, state securities law and common law. Those disclosure mandates would apply to the information content of Event Numbered 15 and Event Numbered 16, as well as to other information that the SEC may have considered, but did not include in this regulatory action.

Financial Obligations under New Event Numbered 15

The amendments to the Rule define a "financial obligation" as a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii). In implementing these amendments, the SEC said that the definition of "financial obligation" does not include ordinary financial and operating liabilities incurred in the normal course of an issuer's or obligated person's business, but only an issuer's or obligated person's debt, debt-like, and debt-related obligations. By distinguishing debt, debt-like, and debt-related obligations from obligations incurred in an issuer's or obligated person's normal course of operations, the amendments to the Rule focus on the types of obligations that could impact an issuer's or obligated person's liquidity, overall creditworthiness, or an existing security holder's rights.[11] It should be noted that the SEC has specifically excluded municipal securities as to which a final official statement has been provided to the MSRB consistent with Rule from the definition of financial obligation.[12]

Debt Obligation. Under the Rule, a "debt obligation" is any short-term or long-term debt obligation of an issuer or obligated person under the terms of an indenture, loan agreement or similar contract, regardless of the length of the debt obligation's repayment period, such as a direct purchase of municipal bonds or a direct loan by a bank, whether long-term or short-term.[13]

A lease is not a debt obligation, except when the lease is debt or debt-like. If a lease operates as a vehicle to borrow money, such as an equipment financing lease or a facilities lease-purchase agreement, it is a debt obligation, but an operating lease is not included in the definition.[15] The SEC noted that, since the Government Accounting Standards Board has discontinued the use of the terms "capital lease" and "operating lease" in government accounting, it is appropriate to focus not on whether the lease is a capital lease or an operating lease, but on whether a lease operates as a vehicle to borrow money. A lease entered into as a vehicle to borrow money could, in the SEC's view, represent competing debt of an issuer; therefore, an obligation to repay borrowed money over time under the terms of a lease is "functionally equivalent" to a similar obligation incurred under the terms of a loan agreement or similar agreement.[16]

Derivative Instrument. The definition of financial obligation includes a "derivative instrument" such as a swap, a security-based swap, a futures contract, a forward contract, an option or similar instrument (or combination) or any similar instrument to which an issuer or obligated person is a counterparty, provided that such instruments are related to an existing or planned debt obligation. The SEC includes derivative instruments in the definition of financial obligation because, it believes, such instruments could adversely impact an issuer's or obligated person's liquidity and overall creditworthiness, or adversely affect security holders.[17]

Guarantee. A "guarantee" is also a financial obligation, as defined in the Rule. A guarantee includes any guarantee provided by an obligated person (as a guarantor) for the benefit of itself or a third party, which guarantees payment of a financial obligation, guarantee of a debt obligation or a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation.[18] The SEC notes that a guarantee of a debt obligation or a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation could raise two disclosures under the amended Rule – one for the guarantor and one for the beneficiary of the guarantee. Specifically, if an issuer or obligated person incurs a material guarantee, such guarantee would be subject to disclosure under the Rule, as amended. For an issuer or obligated person that is the beneficiary of a guarantee provided in connection with a debt obligation or a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation, the SEC suggests that such beneficiary issuer or obligated person should assess whether such guarantee is a material term of the underlying debt obligation or derivative instrument and, if so (and if the underlying debt obligation or derivative instrument is material), disclose the existence of such guarantee under the Rule.

Materiality under New Event Numbered 15

Because materiality is a "core principle" that guides the SEC's approach to securities regulation, only "material" financial obligations or agreements to terms of financial obligations need to be disclosed on EMMA within ten business days after its occurrence under the new Event Numbered 15.[19] The SEC stated that not every incurrence of a financial obligation or agreement to terms is material, but it has offered no hard and fast rules as to what exactly constitutes materiality. Instead, the SEC wants issuers and obligated persons to assess their disclosure obligations in the context of the specific facts and circumstances, and based on whether the information regarding their financial obligations would be important to the "total mix of information made available to the reasonable investor."[20] An issuer or obligated person will need to consider whether a financial obligation or the terms of a financial obligation, if they affect security holders, would be important to a reasonable investor when making an investment decision. The SEC recommends that issuers and obligated persons should consider not only the source of security pledged for repayment of a financial obligation, but also the rights associated with such a pledge (such as senior debt versus subordinate debt), par amount, covenants, events of default, remedies, or other similar terms that affect security holders to which the issuer or obligated person agreed at the time of incurrence, when determining its materiality.

What to Report, and When, under New Event Numbered 15

If, on or after the Compliance Date, an issuer or obligated person determines that it has incurred a material financial obligation, it must disclose such information on EMMA within ten business days after such occurrence. A financial obligation is considered to be incurred when it is enforceable against an issuer or obligated person.[21] A financial obligation incurred before the Compliance Date is not required to be disclosed under new Event Numbered 15, but, as discussed below, a default or other event under such financial obligation may have to be disclosed under new Event Numbered 16.

A disclosure on EMMA under new Event Numbered 15 must include a description of the material terms of the financial obligation, such as the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates). The SEC has indicated that obligated persons can submit to EMMA either a description of the material terms of the financial obligation, or alternatively, or in addition, submit related materials, such as transaction documents, term sheets prepared in connection with the financial obligation, or continuing covenant agreements or financial covenant reports, as long as such related materials include the material terms of the financial obligation. The amendments do not require disclosure of confidential information such as contact information, account numbers or other personally identifiable information, all of which may be redacted.[22]

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Disclosure of Defaults under New Event Numbered 16

As previously noted, new Event Numbered 15 under the Rule is prospective in that it will require an issuer to provide notice on EMMA, pursuant to a continuing disclosure undertaking executed on or after the Compliance Date, if it enters into certain financial obligations thereafter. New Event Numbered 16, however, is retroactive, in that it will require issuers of municipal securities offered on or after the Compliance Date to enter into continuing disclosure undertakings mandating the disclosure on EMMA of any default or other similar event under any applicable financial obligation, regardless of whether such financial obligation was entered into before or after the Compliance Date.

New Event Numbered 16 requires obligated persons offering municipal bonds on or after the Compliance Date to agree to disclose on EMMA any defaults, accelerations, terminations, modifications and other such events under both new and existing financial obligations, if the event "reflects financial difficulties" of the obligated person. A "default" under the Rule may not necessarily be an "event of default" under a financial obligation. The SEC stated that defaults may reflect financial difficulties even if they do not qualify as "events of defaults" under transaction documents, but may still constitute important information related to an issuer's or obligated person's material financial obligations that could impact an issuer's or obligated person's liquidity, overall creditworthiness, or an existing security holder's rights. Similarly, a modification of terms of a financial obligation would have to be reported under a continuing disclosure agreement if the modification "reflects financial difficulties of the issuer or obligated person."[23]

The key is whether any default, modification, waiver or similar event reflects "financial difficulties," but the SEC does not provide much guidance as to what constitutes a financial difficulty. Its notice of the amendments to the Rule states that the financial difficulties standard is intended to "target the disclosure of information relevant to investors in making an assessment of the current financial condition of the issuer or obligated person."[24] Without further explanation from the SEC, issuers and obligated persons will be on their own to determine whether a default, modification of terms or other like event concerning a financial obligation reflects financial difficulties, thereby requiring disclosure on EMMA. However, as the SEC has pointed out, the "reflecting financial difficulties" standard is already a part of the Rule, in reportable events numbered 3 and 4.[25]



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Robert Doty participated for more than 45 years in the corporate and municipal securities markets as bond, underwriter and issuer counsel, underwriter, financial advisor to securities issuers, and special consultant to underwriters and issuers. He worked in billions of dollars of successful corporate and municipal bond transactions in approximately two dozen states. Through his litigation consulting firm, AGFS in Annapolis, Maryland, Mr. Doty continues to serve as consultant to, and municipal bond expert witness on municipal finance in consultation with, legal counsel to municipal securities issuers, underwriters, bond counsel, investors and other parties. Mr. Doty has written numerous books and articles on municipal finance and served as an active member of drafting committees for authoritative market guidance published by the Government Finance Officers Association, the National Federation of Municipal Analysts and the National Association of Bond Lawyers. Mr. Doty graduated from Harvard Law School.

Saul Ewing Arnstein & Lehr LLP is a full-service law firm that offers clients the national reach and sophisticated experience of a large firm and the local connections and value of a boutique firm. With 17 offices in Delaware, the District of Columbia, Florida, Illinois, Maryland, Massachusetts, New Jersey, New York and Pennsylvania, Saul Ewing Arnstein & Lehr serves businesses throughout the United States and internationally, representing recognizable names in corporate America, exciting start-ups and an array of closely held and privately held companies, as well as nonprofits, governmental and educational entities."

Timing of Compliance

The amendments to the Rule will impact only those continuing disclosure agreements entered into in connection with primary offerings of municipal bonds that occur on or after the Compliance Date. The SEC considers an offering to occur on the date the continuing disclosure agreement is executed.[26] However, if a preliminary official statement is posted or distributed before the Compliance Date, with an expectation that the offering will close on or after the Compliance Date, the preliminary official statement should contain a description of, or attach a form of, a continuing disclosure agreement that reflects these amendments to the Rule.

As noted earlier, the new amendments to the Rule do not affect an obligated person's responsibilities under continuing disclosure agreements entered into before the Compliance Date. Issuers will not need to disclose new loans, or defaults under any financial obligation, under any continuing disclosure agreement entered into prior to the Compliance Date. However, if it issues bonds on or after the Compliance Date, an issuer will have to sign a continuing disclosure agreement mandating it to provide the notices required by the recent amendments to the Rule.

Not all publicly offered bond issuances are subject to the Rule, however, so the new amendments to the Rule will not affect certain exempted bond issues, even if issued after the Compliance Date. The Rule does not apply to primary offerings of municipal securities in authorized denominations of $100,000 or more and sold to no more than 35 sophisticated investors who are not purchasing such securities with a view to distributing the securities.[27] Issuers issuing such exempt bonds are not required by the Rule to enter into a continuing disclosure agreement for such issuance.

What to do next

The SEC has given the public finance community until the Compliance Date to

implement new policies, practices and procedures for complying with the amendments to the Rule. Issuers and their dissemination agents, municipal advisors and legal counsel will need to quickly find ways to determine whether a financial obligation is material, or if a default, termination or modification relating to a new or existing financial obligation reflects financial difficulties of the issuer. Existing financial obligations and continuing disclosure agreements may have to be identified and reviewed in order to determine if the new amendments have any impact on existing documents. Existing leases will need to be examined to determine if they could be considered financial obligations under the amendments to the Rule. Municipalities and other bond issuers will need to train their internal disclosure personnel on the effects of the new amendments to the Rule, and how to comply. Existing disclosure procedures and policies will need to be updated. Larger issuers may need to prepare spreadsheets listing all their financial obligations and the material terms thereof.

Underwriters will need to make their own determinations regarding an issuer's financial obligations, and may need to upgrade their due diligence procedures in order to ferret out any undisclosed financial obligations of the issuer. Underwriters will need to review an issuer's financial obligations,[28] and then determine which are deemed financial obligations under the Rule, which are material and which terms might be considered material to investors. Underwriters will need to judge for themselves whether a default, termination or modification relating to a new or existing financial obligation of an issuer reflects financial difficulties of the issuer.[29]

This won't be easy for anyone. The SEC already anticipates that issuers and underwriters will have to devote considerable time and expense to implement the amendments to the Rule, and it acknowledges that issuers and underwriters may need to retain outside counsel to help sort it all out.[30]

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Endotes

1. The term "obligated person" means any person, including an issuer of municipal securities, who is either generally or through an enterprise fund, or account of such person committed by contract or other arrangements to support payment of all, or part of the obligations of the municipal securities to be sold in an offering of municipal securities (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities). *See* 17 CFR 240.15c2-12(f)(10).
2. 17 CFR Part 240 [Release No. 34-83885 (Aug. 20, 2018; File No. S7-01-17], RIN 3235-AL97, 83 FR 44700 (Aug. 31, 2018), Amendments to Municipal Securities Disclosure (the "*Adopting Release*"), page 1.
3. *See* 17 CFR 240.15c2-12(a), (b)(5)(i), (b)(5)(i)(C).
4. The internet website for EMMA is available at http://emma.msrb.org/. The Municipal Securities Rulemaking Board was established by the United States Congress in 1975 and is charged with a mandate to protect municipal securities investors, municipal entities and the public interest. It is a self-regulatory organization governed by a Board of Directors that consists of 21 members with expertise in municipal securities markets, including 11 representatives of the public and 10 representatives of regulated entities.
5. The SEC anticipates that issuers and obligated persons will incur an annual total cost of $4,928,000 in the preparation of additional event notices and that issuers and obligated persons will incur an additional estimated annual cost of $819,000 in fees for designated agents to assist in the submission of event notices. *See Adopting Release*, pages 135-142 for the SEC's discussion of anticipated costs to issuers and obligated persons.
6. The SEC lacks the statutory authority to regulate issuers directly, but it can require underwriters to determine, prior to buying or selling municipal bond, that the issuer or other obligated person has agreed in a written continuing disclosure undertaking to provide certain information on EMMA.
7. Under the Rule prior to these amendments, the following fourteen events require notice in a timely manner not in excess of ten business days after the occurrence of the event: (1) principal and interest payment delinquencies; (2) non-payment related defaults, if material; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting financial difficulties; (5) substitution of credit or liquidity providers, or their failure to perform; (6) adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security; (7) modifications to rights of security holders, if material; (8) bond calls, if material, and tender offers; (9) defeasances; (10) release, substitution, or sale of property securing repayment of the securities, if material; (11) rating changes; (12) bankruptcy, insolvency, receivership or similar event of the obligated person; (13) the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and (14) appointment of a successor or additional trustee or the change of name of a trustee, if material. *See* 17 CFR 240.15c2-12(b)(5)(i)(C).
8. Information regarding the financial obligations of issuers and other obligated persons long has been considered in the municipal securities market to be information that should be disclosed to investors.
9. For example, the Government Finance Officers Association recommended in its *Disclosure Guidelines for State and Local Government Securities (4th ed. 1991)* ("*GFOA Disclosure Guidelines*"), widely-accepted market guidance, recommended at 35-39 a lengthy set of information regarding debt obligations and terms of the obligations, stating at 35:

> Sufficient information should be provided by the issuer or governmental enterprise so that an investor

will be able to evaluate tax and other revenue sources in relation to the obligations or commitments of the issuer or governmental enterprise.

GFOA added at 36:

> The information furnished should also include a separate description of other commitments, such as long-term leases, lease-purchase obligations, installment purchase obligations, joint ventures, guaranteed debt, "moral obligation" indebtedness, output or supply contracts, take or pay or similar contracts and other forms of contingency indebtedness and indebtedness that does not appear on the issuer's balance sheet.

GFOA also recommended that the same information that GFOA recommended for disclosure in primary offerings be disclosed on a continuing basis, including "prompt release" of information regarding event occurrences. GFOA Disclosure Guidelines at 65 *et seq*, 70.

9. The GFOA Disclosure Guidelines provide at 38-39:

> If any securities of the issuer have been in default as to principal or interest payments or in any other relevant respect, or any agreements or legal proceedings of the issuer relating to securities have been declared invalid or unenforceable, at any time in the past 25 years, state the circumstances giving rise to the default or declaration, describe the relevant provisions of the securities and authorizing and governing instruments, and any such agreements or proceedings, and state the amounts involved. State whether the default or declaration has been terminated or waived, and if so, the manner of such termination or waiver.

10. The federal antifraud provisions are SEC Rule 10b-5, 17 C.F.R. § 240.10b-5—promulgated pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)—and Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q.

11. *See Adopting Release*, page 39.

12. *See Adopting Release*, page 58.
13. For the SEC's discussion of what constitutes a debt obligation, see *Adopting Release*, beginning at page 40.
14. For example, lease-purchase agreements may be used in certificate of participation (COP) and appropriation-based financing structures.
15. For the SEC's discussion of whether a lease constitutes a debt obligation, *see Adopting Release*, beginning at page 42.
16. See footnote 141, *Adopting Release*, page 46, in which the SEC states that "the types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificates of participation transactions".
17. For the SEC's discussion of what constitutes a derivative instrument, *see Adopting Release*, beginning at page 48.
18. For the SEC's discussion of what constitutes a guarantee of debt obligation or a derivative, *see Adopting Release*, beginning at page 53.
19. *Adopting Release*, page 22.
20. *Adopting Release*, page 24.
21. *See Adopting Release*, page 32.
22. For the SEC's discussion of the form of an event notice, see *Adopting Release*, pages 33-35.
23. *See Adopting Release*, page 61.
24. See *Adopting Release*, page 64.
25. *Seend* note 7, *supra*.
26. *See Adopting Release*, page 67.
27. Rule 15c2-12(d) provides other full and limited exemptions from the requirements of the Rule. *See* 17 CFR 240.15c2-12(d)(1).
28. In *Disclosure Roles of Counsel in State and Local Government Securities Offerings* (3rd ed. 2009) ("*Disclosure Roles of Counsel*"), the National Association of Bond Lawyers and a Section and Committee of the American Bar Association stated the following at 144 regarding limitations on assistance provided by counsel and the primary responsibilities of underwriters for due diligence relating to financial information:

> In conducting a due diligence investigation, there are (1) certain tasks that the underwriter must conduct itself; (2) certain matters as to which counsel is, in effect, rendering legal advice; and (3) certain tasks that may be delegated to underwriter's counsel as agent of the underwriter, but that do not amount to legal advice. Those matters that are financial — *e.g.*, revenue projections, interest earnings assumptions, debt service coverage ratios-should be reviewed by the underwriter and, because they fall within the province of the underwriter's expertise, should not be delegated to others (although an underwriter may satisfy a portion of its due diligence obligations by, *e.g.*, requesting accountants to review and report on financial statements).

29. Even regarding matters as to which underwriters may have assistance of counsel, Disclosure Roles of Counsel states at 145:

> The underwriter is responsible for all due diligence, whether performed by itself or on its behalf by agents such as underwriter's counsel, and can be held responsible not only for its own actions or inactions, but also for those of its attorneys and other agents. Many bankers, even experienced ones, believe that it is the responsibility of underwriter's counsel to lead and manage the due diligence process, and that the underwriter can confine its role to assessing the credit, coordinating with rating agencies and insurers, and marketing the bonds. That view is misplaced.

30. It should be noted that underwriters counsel do not have contracts with or responsibilities to advise issuers or other obligated persons. Issuers needing assistance of counsel should consult their bond counsel or issuer disclosure counsel pursuant to contractual arrangements. **ML**