Rule 15c2-12 Amendments: Next Steps to Be Ready for the February 27, 2019 Compliance Date

Rule Amendments

Beginning February 27, 2019 (the "Compliance Date"), issuers of state and municipal bonds (and other obligated persons) will be required to include two additional notice events in new undertakings to provide continuing disclosure pursuant to Securities and Exchange Commission (the "SEC" or "Commission") Rule 15c2-12 under the Exchange Act of 1934 (the "Rule").[1] The Rule currently requires an underwriter to determine, prior to purchasing bonds, that an issuer and/or other obligated person has undertaken to provide continuing disclosure to bondholders in the form of annual financial information and notice of certain listed events via emma.msrb.org.

The two new notice events are as follows:

> "(15) Incurrence of a financial obligation of the obligated person, if material, 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; and
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> (16) 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."

The amendment also adds a definition of financial obligation for these purposes.

> "The term financial obligation means 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).

As a result, on and after the Compliance Date underwriters will be required to determine that an issuer and/or other obligated person has undertaken to provide notice, within 10 business days, of the incurrence of a material financial obligation (such as a bank loan or direct purchase obligation) as well as 10 business days' notice of certain agreements and events involving financial obligations.

Issuers and other obligated persons are beginning to prepare for the upcoming Compliance Date by considering whether they have entered into, or plan to enter into, financial obligations that could be subject to reporting, and reviewing continuing disclosure procedures to account for these financial obligations.

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[1] For more information, our prior alert announcing the amendments is available here.

FAQs

A number of questions have arisen as issuers and other obligated persons tackle these tasks, including the following questions:

Can We Rely on Governmental Accounting Standards Board ("GASB") Financial Statement Notes To Identify Financial Obligations? No. The National Association of Bond Lawyers and other commenters noted the recent adoption of GASB Statement 88: "Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements",[2] and requested the SEC define "financial obligation" in a manner consistent with the GASB statement (and consider the extent to which the statement obviated the need for the amendments). In its Release No. 34-83885 (the "Adopting Release"), the SEC acknowledged the GASB statement,[3] but did not conform the definition of "financial obligation" to the GASB definition of "debt" that will be required to be disclosed in financial statement notes.[4] Accordingly, issuers and other obligated persons subject to GASB will not be able to rely on financial statement notes to define the universe of financial obligations that will trigger notice reporting under the amended Rule. Likewise, the specific information regarding each debt required to be included in GASB financial statement notes does not perfectly align with the specific information regarding each financial obligation required to be reported under the amended Rule.[5] An issuer's procedures for identifying and summarizing debt obligations for the purposes of the new GASB requirement should, however, be a helpful starting point for Rule disclosure procedures.

Should We Treat Leases As Financial Obligations? Sometimes. The final Rule deletes the term "lease" from the proposed definition of financial obligation. Nonetheless, the Adopting Release notes that "the term 'debt obligation' generally should be considered to include lease arrangements entered into by issuers and obligated persons that operate as vehicles to borrow money."[6] The amended Rule does not rely on the traditional capital or operating lease treatment of leases[7] or new accounting standards that

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[2] GASB, Statement No. 88: Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements (Mar. 2018) ("GASB 88").

[3] SEC Release No. 34-83885 (effective October 30, 2018) (the "Adopting Release"), at 122.

[4] GASB 88 (effective for reporting periods beginning after June 15, 2018) defines debt as "a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established. For disclosure purposes, debt does not include leases, except for contracts reported as a financed purchase of the underlying asset, or accounts payable." GASB 88, at 2.

[5] GASB 88 requires that note disclosure include "summarized information about the following items: a. Amount of unused lines of credit b. Assets pledged as collateral for debt c. Terms specified in debt agreements related to significant (1) events of default with finance-related consequences, (2) termination events with finance related consequences, and (3) subjective acceleration clauses." *Id.* at 2.

[6] The Adopting Release provides the following examples of leases that would be financial obligations: "For example, the types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificates of participation transactions. Typically, in a lease-revenue transaction, an issuer or obligated person borrows money to finance an equipment or real property acquisition or improvement and a lease secures the issuer's or obligated person's obligation to make principal and interest payments to the lender." *Id.* at n. 141.

[7] *Id.*, at 42. "Thus, although the Commission used the "capital lease" and "operating lease" terminology in the Proposing Release, it is discontinuing the use of such terms in connection with the definition of the term "financial obligation." Instead, as discussed below, the Commission is providing guidance that the term "debt obligation"

establish a single model for lease accounting.[8] Instead, the Rule leaves open to interpretation the determination of when a lease is "used to borrow money" and therefore constitutes a financial obligation subject to notice reporting under the Rule. Leases entered into in the ordinary course should be excluded, under the general direction in the Adopting Release that "the definition of the term 'financial obligation' does not include ordinary financial and operating liabilities incurred in the normal course of an issuer's or obligated person's business, only an issuer's or obligated person's debt, debt-like, and debt-related obligations."[9]

What is the Materiality Standard? Still unclear. The final Rule does not define or provide any new guidance on materiality, deferring instead to existing case law: "the Commission continues to believe that materiality determinations should be based on whether the information would be important to the total mix of information made available to the reasonable investor."[10] Issuers and other obligated persons may consider including in disclosure procedures a reasonable standard for determining whether a financial obligation will be reported, for example a dollar threshold. Note that any dollar threshold should take into consideration that a series of otherwise immaterial obligations may in the aggregate reach a materiality threshold.[11]

Can We Avoid Filing Notice By Filing Official Statements? Yes. The amendments expressly exclude from the definition of "financial obligations" all "municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule."[12] Issuers and other obligated persons may consider whether it makes sense to prepare and voluntarily file a "final official statement"[13] for municipal securities such as bank loans, direct purchase bonds and other obligations (that would otherwise meet the definition of financial obligation) to exclude the obligation from the new notice filing requirement.

What Should Be Included in a Notice that a Financial Obligation Has Been Incurred? A range of options. The Adopting Release notes that issuers and/or other obligated persons have some flexibility with respect to the form of notice that a financial obligation has been incurred. The notice may consist of a summary that describes the "material terms" of the financial obligation. The Adopting Release provides the following examples of material terms: "the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates); other terms may be appropriate as well, depending on the circumstances."[14] Rather than filing a summary, issuers and/or other obligated persons may instead file the transaction documents (such as the term sheet or direct purchase agreement) so long as the filed documents include the material terms.

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generally should be considered to include lease arrangements entered into by issuers and obligated persons that operate as vehicles to borrow money."

[8] See GASB Statement No. 87, Leases (June 2017) (effective for reporting periods beginning after December 15, 2019).

[9] *Id.* at 38.

[10] *Id.* at 23-24.

[11] *Id*. at 31.

[12] § 240.15c2-12(f)(11)(ii); see also Adopting Release at 58-59.

[13] Note the definition of a final official statement under § 240.15c2-12(f)(3) may require a continuing disclosure undertaking.

[14] *Id.* at 33.

Confidential information "such as contact information, account numbers, or other personally identifiable information" may be redacted.[15]

When Is Notice Given for Draw Down Bonds and Lines of Credit? Usually when incurred. The Adopting Release notes that a financial obligation "generally should be considered to be incurred when it is enforceable against an issuer or obligated person" and not at the time of each draw.[16] If certain terms are, however, established only on each draw date, consider whether it is feasible to give notice of all material terms at the time the financial obligation is initially incurred (which may be the date of the first draw or even on an earlier date on which a term sheet is accepted).

What about Swaps – Are They Included? Yes. Swaps and other derivatives "entered into entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation" are included in the definition of financial obligations subject to the Rule's new notice requirements. The Adopting Release "reiterates that the definition captures any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument to which an issuer or obligated person is a counterparty in the adopted definition of 'financial obligation' provided that such instruments are related to an existing or planned debt obligation."[17] Be aware that certain obligations (such as a rate lock or forward starting swap agreement) may be "incurred" prior to the related bond closing date, triggering a pre-closing notice requirement.[18]

When Does the Amended Rule Apply? February 27, 2019, with exceptions. New undertakings entered into on and after the February 27, 2019 Compliance Date must include the two additional notice events.

- *What financial obligations will be covered?* Pursuant to undertakings executed on or after February 27, 2019, issuers and other obligated persons will be required to disclose the incurrence of *new* financial obligations under event (15) and will be required to disclose agreements to terms, events of default, acceleration, termination, modification or similar events reflecting financial difficulties under events (15) and (16) with respect to both *new and existing* financial obligations.[19]

- *What about a POS posted before the Compliance Date?* If an issuer is marketing bonds that will close on or after the Compliance Date, the preliminary and final Official Statements for the bonds should include a form of undertaking that includes the new events.

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[15] *Id.* at 34.

[16] *Id*. at 31-32 ("For example, if an issuer or obligated person enters into an agreement providing for a material drawdown bond, or such agreement contains material terms that affect security holders, the issuer or obligated person generally should provide notice at the time the terms of the obligation are legally enforceable against the issuer or obligated person, instead of each time a draw is made.")

[17] *Id.* at 50.

[18] *Id.* at n. 155 ("If the incurrence of such a swap is material, a forward starting interest rate swap would be disclosed within ten business days of its incurrence because, in the Commission's view, the issuer's or obligated person's contingent obligation to make payments, post collateral, etc. would begin at the point of incurrence of the swap, not if or when the planned debt obligation is incurred because the terms of the swap will be set at the time that the swap is incurred.")

[19] *Id.* at 65 ("[A]n event under the terms of a financial obligation pursuant to paragraph (b)(5)(i)(C)(16) that occurs on or after the compliance date must be disclosed regardless of whether such obligation was incurred before or after the compliance date.")

- *What about a bond authorization adopted before the Compliance Date?* Likewise, if an issuer adopts a bond authorization that includes its undertaking for bonds that will close on or after the Compliance Date, the bond authorization should include a form of undertaking that includes the new events. Issuers may want to consider authorizing the execution of a continuing disclosure agreement instead of incorporating the specific terms of its undertaking in the bond authorization to give flexibility to incorporate the terms of the Rule.

Next Steps: Revising Disclosure Procedures

To prepare for the Compliance Date, we are working with clients to prepare continuing disclosure undertakings for bond issues subject to the Rule that include the additional event notices (15) and (16) as well as the new definition of financial obligation, and are working with clients to review their continuing disclosure policies and procedures to identify any changes needed to ensure compliance with future undertakings subject to the amended Rule.

To be ready to enter into new undertakings after the Compliance Date, issuers and other obligated persons should review any existing post-issuance or other disclosure procedures to be ready to incorporate the two new events to the list of notices to be provided. As part of this review, we suggest issuers and other obligated persons:

- Review existing debt (including leases used to borrow money), derivatives and guarantees to determine whether the issuer or other obligated person has entered into "financial obligations" under the Rule that may be subject to future reporting. Work done to prepare for GASB 88 implementation may be a helpful starting point (but will not be sufficient for purposes of the Rule).
- Consider which financial obligations may meet a materiality standard and articulate that standard.
- Evaluate whether the finance director or other person responsible for the issuer's EMMA filings would know (in sufficient time to file a notice within 10 business days) that a new material financial obligation has been incurred (and if not, add the necessary internal monitoring and reporting steps to give the responsible person time to comply).
- Consider reviewing the specific terms of existing material financial obligations to be ready to report agreements to terms, defaults, events of acceleration, termination event, modification of terms, or other similar events that reflect financial difficulties under the terms of a financial obligation.
- Consider whether it would be helpful to create a database or checklist of the terms that could trigger notice.
- Evaluate whether any such event will be known to the finance director or other responsible person in sufficient time to file a notice within 10 business days of the event (and if not, add the necessary internal monitoring and reporting steps to give the responsible person time to comply).
- Adopt revisions to procedures.
- Communicate the revised procedures through trainings and other tools.
- Draft or review forms of undertakings to include in future issuances after the Compliance Date.

If you have any questions on these securities law topics of interest to state and municipal bond issuers, please contact any of our public finance attorneys.

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