

Municipal Securities Continuing Disclosure: Why Does it Matter?

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**Presented By: Erin P. Bartholomy, Partner
Chapman and Cutler LLP**

Learning Objectives

- Today's presentation is intended to assist attendees with the following:
 - Understanding continuing disclosure undertakings and the amendments to SEC Rule 15c2-12 on municipal securities disclosure effective February 27, 2019;
 - Discussing why complying with continuing disclosure undertakings matters.

What is Continuing Disclosure?

Continuing Disclosure Agreements

- SEC Rule 15c2-12
 - Requires an underwriter to enter into an agreement with issuers of municipal bonds to provide certain financial information and event disclosures to the market
 - SEC believes this information is important for market transparency and to promote a fair and efficient market
- Filings must be made electronically at the EMMA (Electronic Municipal Market Access) portal [www.emma.msrb.org]
- Word-searchable PDF format

What are you required to do?

Continuing Disclosure Filing Requirements

- If new issue is less than \$1,000,000: No CDU
- If new issue is sold directly to a bank: No CDU (generally)
- If new issue is at least \$1,000,000 and Issuer has over \$10,000,000 of debt, Issuer must agree to file on EMMA:
 - Audited financial statements
 - Annual financial information
 - Reportable events, whenever they occur
- If new issue is at least \$1,000,000 and Issuer has less than \$10,000,000 of debt, Issuer must agree to provide:
 - Audited financial statements
 - Reportable events
- Annual Filings to be made within 210 days of end of fiscal year
- Event Filings to be made within 10 days of occurrence of event

There are now 16 “Reportable Events” as of February 27, 2019

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 the 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 Issuer
13. The consummation of a merger, consolidation, or acquisition involving the Issuer or the sale of all or substantially all of the assets of the Issuer, 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
14. Appointment of a successor or additional trustee or the change of name of a trustee, if material
15. **(a) The incurrence of a financial obligation of the issuer or obligated person, if material, or (b) an agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material;**
16. **A default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of an issuer or obligated person, any of which reflect financial difficulties.**

Why Municipal Securities Disclosure Matters: Rule 15c2-12

- Continuing disclosure consists of important information about municipal bonds that arises after the issuance. This information generally reflects the financial health or operating condition of the state or local government as it changes over time, or the occurrence of specific events after issuance that may have an impact on the ability of the issuer to repay the bond, the value of the bond if it is bought or sold prior to its maturity, the timing of repayment of principal, and any number of other key features of the bond.
- Rule 15c2-12 requires dealers, when underwriting certain types of municipal securities, to ensure that the state or local government issuing the bonds enters into an agreement to provide certain information to the MSRB about the securities on an ongoing basis.
- Continuing disclosures are intended to assist investors in determining the suitability of a bond, as well as potential risks associated with the credit of the state or local government.

Who Cares about Continuing Disclosure?

1. The SEC
2. Investors
3. Bond Underwriters

SEC Municipal Enforcement Actions

“Municipalities Continuing Disclosure Cooperation (MCDC) Initiative”

- MCDC Initiative (2014 to 2016)
 - 1st market-wide enforcement action
 - Materially false statements about CDU compliance violate the anti-fraud provisions
 - SEC enforcement efforts in the municipal securities area in 2015 and 2016 were dominated by actions it initiated in March 2014 pursuant to the MCDC Initiative

SEC Municipal Enforcement Actions

MCDC Initiative (*cont'd*)

- SEC Rule 15c2-12
 - Requires an underwriter to enter into an agreement with an Issuer (or “obligated person”) to provide certain financial information, operating data and event disclosures to the market
 - “Obligated person” means any person committed by contract or other arrangement to support payment of all or a portion of the debt service on municipal securities
 - “Obligated persons” do not include conduit Issuers, bond insurers or banks providing credit/liquidity support
 - SEC believes this information is important for market transparency and to promote a fair and efficient market
- Filings must be made electronically at the EMMA (Electronic Municipal Market Access) portal: www.emma.msrb.org
- Statements that are reasonably expected to reach the securities market, even if not prepared for that purpose, cannot be materially misleading

SEC Municipal Enforcement Actions

MCDC Initiative (*cont'd*)

- On February 2, 2016, the SEC completed its MCDC enforcement actions against underwriters by issuing its third round of cease-and-desist orders:
 - **\$18 million** in fines as a result of actions against 72 underwriters (comprising 96% of market share for municipal underwritings)
- On August 24, 2016, the SEC continued its MCDC enforcement actions by issuing cease-and-desist orders to 71 municipalities issuers and obligated persons (state-wide issuers as well as counties, school districts, colleges and universities, small towns and non-profit healthcare providers from 45 states)
- On August 23, 2017, the SEC charged an issuer, an issuer's official (\$37,500), an underwriting firm (\$150,000 penalty) and underwriter (\$15,000) in first post-enforcement actions

Once Again: Why is it important for you to do your annual Continual Disclosure Filings?

- Answer: So we never have an MCDC2!

The Recent Amendments to the Rule

- On August 20, 2018, the Securities and Exchange Commission (the “SEC”) issued Release No. 34-83885 (the “Release”) adopting amendments (the “Amendments”) to Rule 15c2-12 (the “Rule”) under the Securities Exchange Act of 1934, as amended. The Amendments add two new events to the list of reportable events for which an issuer or obligated person must provide notice to the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access (“EMMA”) website.
- The Amendments are effective for continuing disclosure agreements or undertakings entered into **on and after February 27, 2019**. Accordingly, if a transaction is subject to the Rule, and it closes on or after February 27, 2019, the additional listed events must be included in the continuing disclosure agreement or undertaking delivered in connection with the transaction.

The Two New Reportable Events

Under the Amendments, reportable event disclosures under the Rule will now also be required for:

- (15) (a) the incurrence of a ***financial obligation*** of the issuer or obligated person, if material, or (b) an agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material; and
- (16) a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a ***financial obligation*** of an issuer or obligated person, any of which reflect financial difficulties.

Practical Impact on Market Participants (both Events)

- These two additional events provided in the Amendments will now be added to the continuing disclosure undertaking delivered by the obligated person in a primary offering of municipal securities in order for an underwriter to meet its obligations under the Rule beginning on February 27, 2019.
- As with the fourteen existing reportable events, notice of the new reportable events must be given promptly and *not later than **ten business days*** of the occurrence of the event.

The Definition of “Financial Obligation” applies to both Event 15 and Event 16

Under the Amendments, as provided in the release, the term “*financial obligation*” means:

- a ***debt obligation***, a ***derivative instrument*** entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation, and a *guarantee* of a debt obligation or a derivative.
- The terms “**debt obligation**,” “**derivative instrument**” and “**guarantee**” are broadly construed under the Amendments.
- Consistent with the stated purpose of the Amendments, a “**financial obligation**” ***does not*** include *municipal securities* as to which a final official statement has been posted on EMMA in compliance with Rule 15c2-12.

Guidance in the Release regarding what a “financial obligation” is and what it is not under both events 15 and 16

- In the issuing Release, the SEC provided guidance on the meaning of “**financial obligation**”: a “**debt obligation**” includes *both* short-term and long-term debt obligations of an obligated person under the terms of an indenture, loan agreement, lease, or similar contract regardless of the length of the repayment period of the debt obligation.
- **Leases** that “operate as vehicles to borrow money” (*i.e.* financing leases) are financial obligations, but operating leases are not.
- A “**financial obligation**” does include, however, in the municipal financing context, borrowings that might otherwise be exempt from statutory debt limits under state law. The release specifically notes that lease rental obligations, revenue bonds and certificates of participation may be considered “**financial obligations**” even though they are not “debt” under state law or state constitutional provisions.

When is a Lease a “Financial Obligation” (Corporate Obligors)

- The question of whether a Lease is a “**Financial Obligation**” or not is in the private sector (as opposed to the governmental sector), under FASB (Financial Accounting Standards Board) guidelines driven by accounting treatment of Corporate Obligors.
- A lease of a private corporate entity is now characterized as a *financing lease* under GAAP if it satisfies **any one** of the following criteria:
 - ✓ “The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.”
 - ✓ “The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.”
 - ✓ “The lease term is for the major part of the remaining economic life of the underlying asset.”
 - ✓ “The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset.”
 - ✓ “The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.”

When is a Lease a “Financial Obligation” (Governmental Issuers)

- GASB Statement No. 87, “Leases”, to be implemented for reporting periods beginning after December 15, 2019 and the related exposure draft of the related Implementation Guide (for which the comment period just closed on April 30) implements a uniform approach to leases that is presently not helpful in assessing whether a lease is a “**financial obligation**”.
- As stated by GASB: “The guidance for leases [in Statement 87] is based on the foundational principle that [all] leases are financings.”
- A more practical approach may have to be taken in the governmental context in assessing whether a particular lease constitutes a financing lease in the governmental issuer context. That may include applying the FASB criteria for a financing lease on the prior slide to assess whether a governmental lease is a true financing lease and therefore a “**financial obligation**”.

Release Guidance on Materiality, Event 15

- The materiality of a financial obligation or its terms is determined under general securities law standards (*i.e.*, **would the information be important to a reasonable investor in making an investment decision?**), particularly with regard to any rights given to the holder of the financial obligation that are prior to the rights of the holders of the obligated persons outstanding municipal securities.
- Beyond this general statement, the SEC has continued its approach of remaining vague in describing any materiality standard.

What factors are important in judging the materiality of a lease that constitutes a financial obligation?

- In judging whether or not a financing lease that is determined to be a “**Financial Obligation**” is “material” within the meaning of the Rule and applicable federal securities laws guidelines, factors that should be considered, among others, include include:
 - the principal amount of the lease;
 - the principal amount of other obligations that such lease might cross-default by its own terms or by the terms of the obligor’s other debt instruments;
 - cross-collateralization with other debt; and
 - senior, parity or subordinate status of the lease in relation to other debt instruments.

SEC Guidance on what the “Material Terms” of a Financial Obligation are under Event 15

- The SEC states in the Release that the material terms of a financial obligation that should be disclosed under the new event include the following:
 - date incurred,
 - principal amount,
 - maturity dates and amortization,
 - interest rate, if fixed, or method of computation, if variable, and
 - default rates, and
 - such other terms as are “appropriate under the circumstances.”

Reportable Event 16

- (16) a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a ***financial obligation*** of an issuer or obligated person, any of which reflect financial difficulties.

When does a default or modification reflect financial difficulties under the new 16th Reportable Event?

- a default, acceleration, termination, modification or similar event under a financial obligation “**reflects financial difficulties**” of an obligated person and should be reported if the information is relevant to investors in making an assessment of the current financial condition of the issuer or obligated person.
- In the Release, the term “**default**” includes both payment and non-payment defaults, but distinguishes between those that do not reflect financial difficulties (such as failure to provide timely notice of a change in address) and those that do (such as a failure to replenish a debt service reserve fund).

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