

SEC Rule 15c2-12

Navigating the New Continuing Disclosure Requirements



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- The U.S. Securities and Exchange Commission (SEC) has made significant changes to its Rule 15c2-12.
- Applicable to continuing disclosure agreements executed on or after February 27, 2019.
- In the case of conduit issues, the effect of the rule changes would likely be felt by the conduit borrower rather than the issuer.

What does the current Rule require?

- An underwriter (defined to include a placement agent) must review an issuer's continuing disclosure agreement to make sure it complies with the Rule before the underwriter can purchase bonds in a primary offering (or bid for the bonds in a competitive underwriting).

What does the current Rule require?

- The continuing disclosure agreement must require the issuer to:
 - update annually the financial information in the official statement (whether or not material),
 - file annual audited financial statements (when and if available), and
 - provide notices of 14 events within 10 business days after the events occur.
 - All of these filings must be made to the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system (EMMA).

What are the exemptions from Rule 15c2-12?

- When any one of the following exemptions applies, there is no requirement for an official statement or a continuing disclosure agreement.
 - Issue $< \$1,000,000$.
 - The authorized denominations $\geq \$100,000$, and the issue is sold to ≤ 35 financially sophisticated investors purchasing for their own accounts.
 - The authorized denominations $\geq \$100,000$, and the issue has a maturity ≤ 9 months.
- Partial exemptions: $\leq \$10,000,000$ or ≤ 18 months.

What are the changes?

- Two significant additions to the list of events for which notice is to be provided by issuers to EMMA within 10 business days.

What are the changes?

- (15) The incurrence by the issuer on or after the date of the new continuing disclosure agreement of:
 - A material financial obligation, or
 - An agreement to any of the following, any of which affect security holders, if material:
 - Covenants,
 - Events of default (regardless of whether they have arisen to the level of events of default under financing documents),
 - Remedies,
 - Priority rights, or
 - Other similar terms of a financial obligation;

What are the changes?

- (16) The occurrence, on or after the date of the new continuing disclosure agreement, of any of the following related to a financial obligation which reflect financial difficulties, regardless of when the financial obligation was incurred:
 - Default,
 - Event of acceleration,
 - Termination event,
 - Modification of terms, or
 - Other similar events.

What is a “financial obligation”?

- The term “financial obligation” is defined to mean:
 - 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; or
 - A guarantee of a debt obligation or derivative instrument.

Are there exceptions from the definition of “financial obligation”?

- “financial obligation” does not include municipal securities as to which a final official statement has been provided to EMMA consistent with 15c2-12, regardless of whether the official statement (OS) filing is required under 15c2-12 or is done on a voluntary basis.
 - issuer will need to enter into a continuing disclosure agreement as well.

Are there exceptions from the definition of “financial obligation”?

- “financial obligation” does not include ordinary financial and operating liabilities incurred in the normal course of business by an issuer, but rather only an issuer’s debt, debt-like, and debt-related obligations.

What is a “debt obligation”?

- Per the Adopting Release, “debt obligation” is broad in scope and is not limited by state law definitions of debt.
- Vehicles for borrowing money, regardless of what they are called
 - no carve out for “loans”

What kind of leases are considered debt obligations?

Debt-Like

- lease-revenue transactions and
- certificates of participation transactions.

Not Debt-Like

- commercial office building leases,
- airline and concessionaire leases at airport facilities, and
- computer and copy machine leases.

What kind of leases are considered debt obligations?

- Although the Governmental Accounting Standards Board (GASB) no longer uses the terms “capital leases” and “operating leases,” that prior distinction may be a useful way to think of the distinction between leases that are debt-like and those that are not.

What factors determine whether a financial obligation is material?

- The SEC has identified the following factors, but there may be others:
 - Source of security pledged for repayment of the financial obligation,
 - Rights associated with such a pledge (e.g., senior versus subordinate),
 - Principal amount or notional amount (in the case of a derivative instrument or guarantee of a derivative instrument),
 - Covenants,
 - Events of default,

What factors determine whether a financial obligation is material?

- Remedies,
- Other similar terms that affect security holders to which the issuer agreed at the time of incurrence,
- Size of the overall balance sheet,
- Size of existing obligations, and
- Size of the overall bond portfolio.

What if there is a series of transactions? Do they need to be aggregated to determine whether they are material?

- Materiality is determined upon the incurrence of each distinct financial obligation.
- The Adopting Release refers to IRS regulations on the definition of “issue” and the IRS regulations on abusive transactions as examples of when transactions might need to be aggregated to assess materiality.

Financial obligations are required to be reported when they are “incurred.” What does that mean?

- Incurred = when it is enforceable against an issuer.
- E.g. drawdown bond

What kinds of derivatives are considered “financial obligations”?

- any swap,
- security-based swap,
- futures contract,
- forward contract,
- option,
- any combination of the foregoing, or
- any similar instrument to which an issuer is a counterparty provided that such instruments are related to an existing or “planned debt obligation.”
 - Sometimes, even of a third party.

What are some examples of when guarantees of debt obligations would need to be disclosed?

- The SEC has said that both the guarantor and the beneficiary of the guarantee might need to disclose the guarantee.
- Self-liquidity for variable rate demand obligations (VRDOs) is an example of a guarantee that would need to be reported.

Do the changes to Rule 15c2-12 impose any new obligations on underwriters?

- The changes increase the amount of due diligence that will be required of underwriters.
- The SEC has stated that underwriters must have a reasonable basis for belief in the accuracy and completeness of an issuer's official statement description of their ongoing continuing disclosure duties.
- Third-party vendor reports work well but have limitations
- Underwriters will need to find some other way to assess whether their clients will comply with their post-February 26, 2019, continuing disclosure agreements.

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

The Governmental Finance Officers Association (GFOA) “recommends that finance officers responsible for their government’s debt management program adopt a thorough continuing disclosure policy.”

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

- Catalogue your existing “financial obligations.” This may entail reaching out to other departments within your government.

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

- Create summaries of the existing terms of those financial obligations, including the following:
 - Date of incurrence
 - Principal amount
 - Maturity
 - Amortization
 - Interest rate, if fixed
 - Method of calculation of interest rate, if variable
 - Any default rates
 - Security
 - Key Covenants (details on next slide)

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

– Key covenants

- Events of default
- Events of acceleration
- Termination events
- Most favored nation clauses (i.e., clauses permitting the purchaser to obtain the benefit of more favorable covenants negotiated with other purchasers)
- Gross-up provisions

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

- Assess what “financial obligations” you consider to be material and memorialize that analysis.

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

- Determine who will be charged with monitoring whether:
 - You have incurred any new material financial obligations;
 - You have agreed to any of the following with respect to a financial obligation, any of which affect security holders, if material:
 - Covenants,
 - Events of default (regardless of whether they have arisen to the level of events of default under financing documents),
 - Remedies,
 - Priority rights, or
 - Other similar terms; and

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

- Whether any of the following events has occurred with respect to a financial obligation and whether that occurrence “reflects financial difficulties”:
 - Default,
 - Event of acceleration,
 - Termination event,
 - Modification of terms, or
 - Other similar events.

What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

- Determine your the process for reporting events to EMMA within 10 business days after incurrence
 - A summary of terms described above may be used to report the incurrence of a new financial obligation to EMMA.

What else might underwriters request?

- Underwriters must independently diligence issuer representations in their official statements
- It is likely that underwriters will want to assess whether anything is missing from your catalogue of financial obligations.
 - Governing body meeting agendas

Stifel looks forward to working with you to make implementation of these rule changes as manageable as possible. The key is starting early by understanding the rule changes and developing a thoughtful process that is tailored to your needs. We stand ready to work with you, as well as your municipal advisor, if applicable, and your bond counsel, to address the many questions that undoubtedly will arise.

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