Implementing Compliance with Amendments to Rule 15c2-12

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We recently reported the SEC’s adoption of amendments to Rule 15c2-12 to add two new events to those now required to be reported. Those two events are:

• Incurrence of a financial obligation of the issuer or obligated person, if material, or 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.

• Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of the financial obligation of the issuer or obligated person, any of which reflect financial difficulties.

The term “financial obligation” means: “a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as a security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii).” Municipal securities for which a final official statement is available on the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access (EMMA) website are excluded from the definition of “financial obligation.”

The SEC’s stated purpose for the amendments is to facilitate investor’s and other market participants’ access to timely disclosure of important information related to a municipal securities issuer’s or obligated person’s material financial obligations that could impact the reporting person’s liquidity, overall creditworthiness, or an existing security holder’s rights.

Compliance Date

The compliance date for the amendments is February 27, 2019. Accordingly, any primary offering of municipal securities subject to Rule 15c2-12 that occurs on or after February 27, 2019 will be required to have a continuing disclosure agreement that includes the two new events as disclosure triggers. While an offering generally occurs on the date the continuing disclosure agreement is executed, the SEC noted in the adopting release that if a preliminary official statement is circulated prior to the compliance date for an offering that will occur on or after that date, the new events should be included in the preliminary official statement. We recommend that reporting persons and underwriters use the time before that date to prepare to comply with the amendments. We outline below some of the key considerations and potential pitfalls in these new disclosure events, as well as steps that can be taken to implement compliance.

Incurrence of a Financial Obligation

In many cases, financial obligations for which incurrence must be reported will be obvious. For example, the new item is clearly designed to pick up privately-placed bonds and bank loans and similar credit facilities for which disclosure has not been required. Other types of financial obligation, however, may not be as obvious. One is a lease that is entered into as a means to borrow money and thus is appropriately categorized as a debt obligation within the definition of financial obligation. What falls within this subset of debt obligation is not entirely clear. By eliminating “leases” as a separate category, as was originally proposed, and by declining to tie the reporting requirement to the historic accounting concept of “capital leases” as contrasted with “operating leases” (a distinction that is disappearing from accounting standards), we believe that the SEC is focusing on a narrower category of leases that substitutes for an actual borrowing – i.e., “a
vehicle to borrow money.” As guidance, the SEC gives as non-exclusive examples in the adopting release “lease-revenue transactions” and “certificates of participation transactions.” Absent further guidance, a useful starting point may be leases that have been classified as capital leases for financial reporting purposes. The SEC guidance also makes clear that “debt” is not limited to obligations characterized as debt under state law. Thus, just because an obligation is subject to appropriation and may not be considered “debt” for some purposes under state law does not mean that it is not a debt obligation. The SEC also makes clear that no minimum time for repayment is required, thus encompassing within debt obligations both short-term and long-term debt.

In contrast to the broader requirement in the SEC’s proposal, only derivative instruments related to a debt obligation will need to be reported. Typical derivative instruments to which the requirement could apply include interest-rate only swaps, security-based swaps, future contracts, forward contracts, options and rate locks. Some of these may be entered into well in advance of a proposed financing and would have to be disclosed at that earlier time.

Similarly, guarantees made by an issuer or obligated person will only need to be reported if they are a guarantee of a debt obligation or of a derivative instrument related to a debt obligation of another person. In addition to a guarantee made by an issuer or obligated person reportable as a financial obligation, an issuer or obligated person could be the beneficiary of a guarantee of a third-party (such as when a private party guarantees the obligation of a municipal entity). While not reportable as a financial obligation, that third-party guarantee might be a material term of the reporting person’s obligation and financial difficulties of the guarantor could result in a reportable material event indicating financial difficulty of the reporting person.

An area that could require the exercise of judgment will be the determination as to which terms of an agreement, such as covenants, events of default, remedies, priority rights and similar terms, will need to be described as material provisions in the required disclosure. Answering this will depend on the circumstances, and past practices, both in municipal securities and corporate filings, as well as practices that will develop over the coming months, can be looked to for precedent.

In addition, the events indicating financial difficulty (the second item of the amendments) could inform what needs to be described. An approach that could be followed to avoid having to make this determination would be to file the entire agreement (with any appropriate redactions). If this approach is taken, we recommend including a summary that describes the terms considered material. The SEC gives as examples of material terms the date of incurrence, principal amount, maturity and amortization, interest rate or method of computation (including default rates) and tax-related provisions such as rate adjustments and call provisions. Other terms, such as sources of payment, collateral, priority of rights, unusual covenants, events of default and remedies and third-party guarantees, also might be material depending on the nature of the obligation, the issuer and other circumstances.

Both the incurrence of a financial obligation and related provisions required to be disclosed are subject to a materiality standard. The SEC declined to provide further guidance on what is material but instead cited to the commonly understood definition of whether disclosure would be important to an investment decision by a reasonable investor, which could involve both quantitative and qualitative considerations. Thus, determining materiality requires the exercise of judgment and will be based upon the particular facts and circumstances.

**Defaults and Similar Events**

A particularly difficult area will be reporting monetary and non-monetary defaults and other events related to financial obligations that reflect financial difficulty. Once a new continuing disclosure agreement is executed on or after the February 27, 2019 compliance date, any such event that occurs with regard to a financial obligation whenever incurred, whether before or after the compliance date, will have to be reported. This differs from the incurrence event, which will apply only to material financial obligations incurred after a continuing disclosure agreement that includes that event is executed. There is no separate materiality standard – rather the test is whether the event reflects reporting person financial difficulty. The SEC indicated that this term
relates to events that may have potential adverse impacts on the reporting person’s liquidity and overall creditworthiness, or affect security holders. That determination will require the exercise of judgment, and caution will likely result in reporting if there is any uncertainty on whether the test is met. To deal with compliance with this new event, it will be important for reporting persons to know the key provisions of their financial obligations and to have procedures in place to identify and evaluate any such events.

**Steps to Implement Compliance**

We have the following advice to assist with compliance with the new requirements:

**For reporting persons:**

- Review in advance of the compliance date (or at least before the first offering subject to Rule 15c2-12 after that date) the existing disclosure controls and procedures to identify what changes may be needed to deal with the two new event items. This will include identifying who will be responsible for determining when a financial obligation, as defined, has been incurred and ensuring that necessary information will flow to that person.
- Educate those responsible for compliance about the new requirements for continuing disclosure.
- Catalogue existing financial obligations determined to be material, along with a listing of relevant material covenants and other provisions in order to be in a position to timely identify events reflecting financial difficulties that will need to be reported. Review of financial statements will be a helpful way to help identify existing financial obligations. Use of a spreadsheet or electronic database also could be helpful. This information should be kept current on an ongoing basis.
- Following the first offering with a continuing disclosure agreement containing the new items, assess each new financial obligation proposed to be incurred to determine if disclosure is required. Doing this assessment at the outset of planning the incurrence will facilitate compliance.
- Also following that first offering, continuously monitor events to determine if a default or similar event has occurred reflecting financial difficulties and thus requires disclosure. While financial difficulties and resulting defaults and related events are unlikely to be a surprise, it would make sense to have this analysis done, using the spreadsheet or database, at least each time financial statements are prepared or on some other periodic basis.

**For underwriters and municipal securities dealers:**

- Review and enhance procedures for ensuring that municipal issuers and obligated persons are complying with the new continuing disclosure requirements. This could involve steps to understand what procedures particular reporting persons have in place to ensure compliance and modification of forms of continuing disclosure agreements and certificates as to compliance to be obtained from such persons in connection with offerings after the compliance date.
- Once a municipal issuer or obligated person has issued municipal securities with continuing disclosure agreements that include the new items, engage in diligence using the enhanced procedures to determine whether there has been a failure to comply in all material respects with the compliance disclosure agreements. Review of financial statements posted on EMMA to identify a reporting persons financial obligations can be an important part of the compliance review procedures. As noted above, the leases required to be disclosed in a filing are fewer than those that will be reflected on the financial statements. Third party resources, such as those of Digital Assurance Certification (DAC) and others, also could be helpful in this task. In addition, knowing the reporting persons procedures and obtaining appropriate certificates should be part of the diligence process.
- Dealers who recommend purchases or sales of municipal securities also will want to develop procedures to provide reasonable assurance that they will receive prompt notice of the events and failure to file notices regarding the securities being recommended. Again, third party resources can be helpful.
Early Adoption?
We have been asked by several issuers and obligated persons whether they should comply early by including the new events in their continuing disclosure agreements entered into before the compliance date. Our advice is to wait, most likely until the compliance date, before doing so. As we have noted above, there are questions about the new requirements that can benefit from further guidance. Moreover, reporting persons will need time to revisit and upgrade their disclosure controls and procedures to ensure compliance. Reporting persons can always voluntarily disclose particular events they consider material, such as incurring new financial obligations or events indicating financial difficulties, and we generally encourage considering doing so.

Further Information
We will continue to monitor developments on this matter as they progress and provide updates as necessary. In the meantime, if you have any specific questions, please contact us:

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