Welcome to APFP's Fall 2018 Educational Seminar

Continuing Disclosure and the Impact of the 2018 Amendments to SEC Rule 15C2-12 on the Public Finance Industry

Association of Public Finance Professionals
Tuesday, October 16, 2018

APFP's Fall 2018 Educational Seminar Panel

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Amendments to SEC Rule 15c2-12

Impetus for the amendments: increasing use of private placements, direct purchases of municipal securities and direct loans as alternatives to public offerings of municipal securities. SEC's aim was to increase transparency of debt outside of the "bond" market because of the amount of such debt since the financial crisis. One estimate: bank loans made to state and local governments increased from $66.5 billion as of end of 2010 to about $190 billion by the end of the 1st quarter of 2018.

S&P wrote, "The amendments will give us a fuller and more consistent view of the risks associated with these financial obligations and therefore enhance our ratings' ability to capture and reflect them."

SEC's initial proposal was broader and would have required notices of various types of judgments and certain leases, but final rule tailored rule more narrowly.

Effective for continuing disclosure agreements executed on or after February 27, 2019. The amendments add two new paragraphs (15) and (16) which:

(a) amend the list of events for which notice is to be provided to the MSRB not in excess of 10 business days to include

Amendments to SEC Rule 15c2-12

(i) incurrence of:

(a) a financial obligation of the obligated person, if material, or

(b) 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

(ii) 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; and

(b) define (see new paragraph (f) (11)) the term "financial obligation" to mean 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) a guarantee of (i) or (ii).

Amendments to SEC Rule 15c2-12

The term financial obligation does not include municipal securities themselves (but does include any associated financial obligations such as a derivative instrument entered into in connection with the municipal securities) as to which a final official statement has been provided to the MSRB consistent with 15c2-12, regardless of whether the OS filing is required under 15c2-12 or is done on a voluntary basis.

Amendments to SEC Rule 15c2-12

The Adopting Release (SEC Rel. No. 34-83885 (August 20, 2018)) accompanying the amendments contains many interpretations of the rule language, including the following:

Materiality

Factors to consider when assessing whether a financial obligation is material, include:

- 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,
- remedies,
- other similar terms that affect security holders to which the issuer or obligated person agreed at the time of incurrence,
- size of the overall balance sheet,
- size of existing obligations, and
- size of the overall bond portfolio.

Amendments to SEC Rule 15c2-12

Materiality is determined upon the incurrence of each distinct financial obligation, taking into account all relevant facts and circumstances. If the issuer or obligated person enters into a series of transactions that, though related, are incurred at different points in time for legitimate business purposes – e.g., to satisfy the qualified bank bond rules of the IRS, the financial obligations would not need to be aggregated to assess their materiality. The 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 aggregate to assess materiality.

Incurrence of a Financial Obligation; Draw Down Bonds

Incurrence of a Financial Obligation; Draw Down Bonds

A financial obligation generally should be considered to be incurred when it is enforceable against an issuer or obligated person. (Note: In the view of at least one law firm, when a contractual commitment or sale agreement has been entered into prior to closing or funding, it may be prudent to treat the "incurrence" as occurring upon the sale or commitment date rather than the closing date.)

For example, if an issuer or obligated person enters into an agreement providing for a drawdown bond, 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.

Form of Event Notice

Form of Event Notice

When issuers or obligated persons submit a material event notice for the incurrence of a financial obligation they may either submit the financing documents themselves and/or include a description of the material terms of the financial obligation. Examples of some material terms may be the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates). They may also submit term sheets, continuing covenant agreements, or financial covenant reports to EMMA. Material terms must be included; however, confidential information such as contact information, account numbers, or other personally identifiable information is not required to be provided to EMMA.

Financial Obligation

Financial Obligation

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.

Debt Obligation

Debt Obligation

The term “debt obligation” includes short-term and long-term debt obligations of an issuer or obligated person under the terms of an indenture, loan agreement, lease, or similar contract, regardless of the length of the debt obligation’s repayment period.

A “similar contract” could, for example, include a line of credit obtained from a bank or other lender.

Debt Obligations

Examples of leases that are typically not vehicles to borrow money that are common among issuers and obligated persons include, but are not limited to: commercial office building leases, airline and concessionaire leases at airport facilities, and copy machine leases.

The types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificates of participation transactions. The term “debt obligation” is not limited to debt as it may be defined for state law purposes, but instead is applying it more broadly to circumstances under which an issuer or obligated person has borrowed money.

Derivatives

Derivatives

The definition of “derivative” used in the amendments is intended to include 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 provided that such instruments are related to an existing or planned debt obligation.

This includes, under certain circumstances, instruments that are related to an existing or planned debt obligation of a third party. Derivatives that mitigate investment risk are not covered.

Derivatives

A debt obligation is “planned” at the time the issuer or obligated person incurs the related derivative instrument if, based on the facts and circumstances, a reasonable person would view it likely or probable that the issuer or obligated person will incur the related yet-to-be-incurred debt obligation at a future date. In the Commission’s view, it would be likely or probable that an issuer or obligated person will incur a future debt obligation if, for example, the relevant derivative instrument would serve no economic purpose without the future debt obligation (regardless of whether the future debt obligation is ultimately incurred). This would be the case with a forward interest rate swap.

Factors relevant to whether an issuer’s or obligated person’s debt obligation is “planned” might include, but are not be limited to, whether: (1) the documents evidencing the relevant derivative instrument explicitly or implicitly assume a future debt obligation; (2) the legislative body of the issuer or obligated person has taken any preliminary (e.g., preliminary resolution) or final (e.g., authorizing resolution) action to authorize the related future debt obligation; or (3) the issuer or obligated person has hired any professionals (e.g., municipal advisor, bond counsel, rate consultant) to assist or advise the issuer or obligated person on matters related to the future debt obligation.

Guarantees

Both the guarantor and the beneficiary of the guarantee might need to make the disclosures. Self-liquidity for VRDOs is an example of a guarantee that would need to be reported.

Default

A default could be a monetary default, where an issuer or obligated person fails to pay principal, interest, or other funds due, or a non-payment related default, where an issuer or obligated person fails to comply with specified covenants. There are defaults that may reflect financial difficulties even if they do not qualify as “events of defaults” under transaction documents.