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The SEC's Proposed Changes to Rule 15c2-12 Could Have Far-Reaching Impact on Issuers and Obligors of Municipal Securities: Foley & Lardner

Introduction

On March 1, 2017, the Securities and Exchange Commission ("SEC") issued Release No. 34-80130 (the "Release") proposing several amendments to its Rule 15c2-12 (the "Rule") that would add two new events to the list of events that must be included in the continuing disclosure undertakings of municipal issuers or obligors of municipal bonds.

- The first additional event, in general, is the incurrence of "financial obligations, if material, or agreeing to covenants or other provisions that affect security holders, if material," and
- The second reportable event is the occurrence of one or more of the following events under the terms of such a financial obligation: "default, event of acceleration, termination event, modification of terms or other similar events under the terms of a financial obligation of the obligated person," if the event reflects financial difficulties.

The compliance date of the proposed amendments would be no earlier than three months after any final approval of the proposed amendments, should the SEC adopt the proposed amendments in final form.

Many participants in the municipal securities market have called for greater transparency surrounding issuer's or obligor's bank loans or direct purchases of municipal securities ("direct placements"), but the scope of the proposed amendments is far broader than simply requiring disclosure of such direct placements.

Under the Release, the term "financial obligation" is very broadly defined and includes, in addition to a debt obligation such as a direct placement– leases, guarantees, derivatives or monetary obligations arising from a judicial, administrative or arbitration proceeding. Coupled with the qualifier "if material," which the SEC has not clarified in the context of the Rule, issuers and obligors may feel compelled to disclose a great deal of information. The use of the term "lease," which the Release defines as including both capital and operating leases, could open the door to reporting a significant number of obligations, especially in certain market sectors, as discussed below. Similarly, in the second proposed additional event, the use of the term "default" intentionally captures events earlier in time than when an "event of default" is declared and, if such default "reflects financial difficulties," the event must be disclosed and the context provided.

This Client Alert will provide background concerning the Rule and describe the terms and scope of the proposed amendments to the Rule. It then will examine some of the issues that these proposed amendments raise in the context of the municipal market. Lastly, it will suggest some strategies for participants in the municipal market to address the challenges posed by these proposed amendments. Note that the SEC will accept comments during a 60 day period that begins on the date of publication in the Federal Register, although comments on the underlying financial impacts are due to the Office of Management and Budget ("OMB") within 30 days. Given the breadth of the proposed amendments, as well as the potential for a significant amount of work created for issuers and obligors, comments to both the SEC and OMB are likely to be helpful.

Background

The SEC has indirectly regulated disclosure by issuers and obligors of municipal securities pursuant to the Rule by requiring that the broker-dealers underwriting an issue of bonds obtain a written undertaking from the issuer or obligor to provide certain annual financial data and timely notice of certain events that primarily relate to the offered securities to the Municipal Securities Rulemaking Board's ("MSRB") Electronic Municipal Market Access ("EMMA") website. In addition, in connection with the issuance of the municipal securities, an underwriting broker-dealer must reasonably determine that the issuer or obligor has complied with its prior continuing disclosure undertakings, or accurately disclosed in its Official Statement relating to such securities any failures to comply with such undertakings, within the past five years.

Since 2009, issuers and obligors have increasingly used direct placements as substitutes for publicly offered municipal securities. Direct placements can be beneficial to issuers and obligors for several reasons, including the lack of a requirement to provide the purchaser or lender with an official statement and generally lower transaction costs. Although many such transactions are issued pursuant to the same underlying legal documents as the issuer's or obligor's outstanding bonds, many others include additional covenants or other provisions for the benefit of the purchaser or lender, often set forth in a separate continuing covenants agreement or a similar instrument. Currently, there is no regulation which requires either an issuer or obligor or a broker-dealer to post direct placement documentation on EMMA.

A number of market participants, particularly municipal analysts and rating agencies, have called for issuers and obligors to provide disclosure through EMMA regarding these direct placements, since the additional debt has the potential to materially alter the analysis of the issuer's or obligor's financial condition. Further, because in certain instances the additional terms and financial covenants agreed to by the issuer or obligor could have a material impact on the rights of the holders of outstanding publicly held bonds, these commentators have also sought to have these terms and financial covenants disclosed. A number of issues and obligors have voluntarily provided the requested information regarding such direct placements to EMMA. However, the SEC has noted that many other issuers and obligors have not made such information regarding direct placements available on EMMA, leading to a lack of information in the market regarding these securities or, in some cases, information "asymmetry" among various market participants.

In addition to information regarding direct placements, the SEC states that some market participants have called for issuers and obligors to provide information to EMMA regarding derivatives, such as interest rate swaps, and capital and operating leases, that is not currently required to be disclosed under the Rule.

The Proposed Amendments

Accordingly, in order to address the lack of publicly available information regarding direct placements and other "financial obligations," the SEC has proposed to amend the Rule to require timely disclosure of "financial obligations of the obligated person, if material" and of any agreement that includes "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." In addition, the proposed amendments would require issuers and obligors to provide timely notice of a "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." These amendments would apply to continuing disclosure undertakings for municipal securities issued after the effective date of the proposed amendments, and would not be retroactive, in general. The amendment does not provide the elements that would need to be included in a notice filed with EMMA.

Unpacking the Proposed Amendments

Scope of "financial obligations" that must be disclosed. The clear focus of the Release and the proposed amendments to the Rule is provision of continuing disclosure relating to direct placements, but the scope of the proposed amendments is significantly broader than direct placements. The term "financial obligation" is defined to include a "(i) debt obligation, (ii) lease, (iii) guarantee, (iv) derivative instrument, or (v) monetary obligation resulting from a judicial, administrative, or arbitration proceeding." Further, these terms are interpreted broadly in the Release, For example, the Release provides that the term "lease" is intended to include an operating lease or a capital lease, while a "guarantee" is intended to capture a contingent financial obligation of the issuer or obligor to secure the obligations of a third party or of the issuer or obligor itself. Thus, an extremely wide range of obligations, if material, would need to be disclosed to EMMA by issues and obligors if the amendments are adopted, as proposed.

Impact of "materiality" qualifier. A second area of concern is the use of materiality to qualify those events that must be disclosed. This qualification ideally would limit the amount of disclosure that must be provided only to events where there is a substantial likelihood that a reasonable investor would consider such information important in making an investment decision, based on the Basic v. Levinson standard of materiality. However, as was evidenced by the SEC's recent Municipal Securities Disclosure Cooperation ("MCDC") initiative, there is a lack of clear guidance regarding what is material to an investor in the municipal market, leading to a conservative view of materiality and what one market participant has termed "hyper disclosure".

Determining which events are "material" to a reasonable investor could be difficult and, if the SEC does not later concur with the issuer's or obligor's analysis, the consequences can be severe. Thus, use of the materiality standard (without further guidance) to qualify the events that must be disclosed gives rise to the concern that issues and obligors will be required to provide detailed summaries of its direct placements, leases, swaps, for example, or to post in full redacted copies of the underlying documentation, in order to comply with the Rule.

Particular impact on certain municipal sectors. A corollary concern is that for certain sectors of the municipal market, this approach could give rise to a flood of information in an attempt to meet the requirements of the Rule, while not actually providing real insight into the issuer's or obligor's actual financial situation. For example, most airports structure their arrangements with the parties doing business at the airport, such as airlines, rental car companies and concessionaires, through leases. The sheer volume of leases to which a large airport is a party could overwhelm participants in the municipal market, as it is likely that such issuers and obligors will choose to simply post redacted versions of the relevant documents. Similarly, many healthcare systems both own medical office buildings and lease space to third parties, as well as lease other space themselves. The volume of such leases, especially for a large system, also could be substantial. This volume of data (and related workload to assemble such documentation) does not appear to be reflected in the economic analysis performed by the SEC in connection with the Release.

Events "reflecting financial difficulties." One of the themes of the Release is that, the timing of such financial difficulties disclosure under current law is often delayed because it is included in an annual filing, or such disclosure may not include the detail that would be required under the proposed amendments. In the Release, the SEC also notes that certain events that would indicate that the issuer or obligor was experiencing financial difficulties are not currently required to be disclosed under the Rule. Thus, the second added event of the proposed amendments would require an issuer or obligor to provide timely notice of any of the following events: “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.”

In the Release, the SEC first notes that the qualifying trigger that any of the events must “reflect financial difficulties” should allow issuers and obligors to distinguish between events that do not reflect financial difficulties, such as failure to comply with a covenant to provide notice of a change of address, compared to the failure to replenish a debt service reserve fund. The former is unlikely to be evidence that the issuer’s or obligor’s ability to pay its obligations when due has been compromised, while the latter could indeed be indicative of financial distress. However, this qualifier, like materiality, has not been clearly defined nor has the SEC provided guidance on how this standard should be interpreted. Note, also, that this requirement will apply to a listed event relating to any of the issuer’s or obligor’s financial obligations, not solely those entered into after the date of the amendment of the continuing disclosure undertaking required by the Rule, if amended as proposed.

Timing of disclosure of events. The use of certain terms in the proposed amendments will require issuers and obligors carefully to maintain up-to-date data on the status of all of their “financial obligations,” as defined by the SEC. For example, use of the term “default,” rather than “event of default,” intentionally requires disclosure of an event at an earlier point in time than is generally required under the Rule currently, since an “event of default” typically accrues following some notice and cure period, while a “default” is the failure to act or the taking of a prohibited action. Thus, even if a default is cured before it amounts to an event of default, if the default itself reflected financial difficulties, it must be disclosed. This can be contrasted with an acceleration event or termination event, which are typically actions taken once an event of default has occurred, cure rights have been exhausted, and the counterparty has determined to exercise its remedies.

Similarly, a modification of terms is often a negotiated response to a situation which may or may not rise to the level of a default or which may result in the waiver of a default. For example, where an issuer or obligor fails to meet a financial covenant, such as a minimum debt service coverage ratio, but still has adequate financial resources to pay its operating expenses and debt service as and when due, it is not uncommon for the lender and issuer or obligor to agree to a temporary (or permanent) amendment of the covenant in exchange for certain actions, such as engaging a consultant to recommend methods to increase revenues or reduce expenses, or both. Under the proposed amendments to the Rule, any such amendment would need to be disclosed, along with the surrounding terms and conditions relating to the amendment, if such modification of terms “reflects financial difficulties.”

A note about responsibilities of broker-dealers. Although most of the foregoing discussion relates to the potential impact on issuers and obligors of the proposed amendments to the Rule, the Rule requires broker-dealers to have a reasonable basis for concluding that the issuer or obligor has met its obligations under its continuing disclosure undertakings and that any material failures have been disclosed. Under the current list of events that must be disclosed pursuant to the Rule, the scope of a broker-dealer’s inquiry is fairly limited and the due diligence necessary to comply with this requirement is relatively straight-forward (though not simple). Under the proposed amendments, broker-dealers would have a far greater scope of events that require disclosure and, therefore, a far more complex due diligence process will be necessary. This is especially critical because the SEC has indicated that simply relying on a certification of the borrower without additional inquiry is not sufficient to discharge the broker-dealer's duties under the Rule. Thus, broker-dealers will need to develop a significantly more robust due diligence process (or cause their counsel to review a wider array of documentation) in order to comply with the Rule if the amendments are adopted as proposed.

Steps to Prepare for the Amendments

As described above, the amendments to the Rule proposed in the Release could have a significant impact on the municipal market, especially upon issuers and obligors, but also on broker-dealers. Set forth below are several actions that issuers, obligors and broker-dealers may wish to consider undertaking in response to this proposal.

Review and Comment. First, the SEC has solicited comments on the proposed amendments to the Rule and on the Release, including comments to both the SEC and OMB on the economic analysis set forth therein. Issuers, obligors and broker-dealers may want to submit comments; for example comments regarding the scope of the proposed amendments, difficulties that parties anticipate in complying with the proposed amendments and suggestions for addressing those difficulties, and comments on the assumptions underlying the SEC's economic analysis. Given the new administration's recent Executive Order restricting the issuance of new regulations, comments on the economic impact of the proposed amendments may require the SEC to undertake a much more exhaustive analysis before the proposed amendments can be adopted. Further, examples of the potential difficulties that these amendments, as proposed, may cause issuers and obligors or broker-dealers may allow the SEC to tailor the proposed amendments more narrowly to achieve the SEC's stated goals, while limiting unintended and unnecessary collateral consequences.

Review Current Arrangements and Disclosure Policies. If the proposed amendments to the Rule are adopted, even in a more limited form, issuers and obligors will need to be prepared to gather and disseminate a considerably wider scope of information regarding their financial obligations than is currently the case. It would likely be prudent for issuers and obligors to review their existing disclosure undertakings and policies and consider what modifications may be necessary to comply with the Rule as amended. Further, because of the potentially broad scope of such requirements, the person or persons responsible for filing event notices with EMMA will need to develop processes and procedures for becoming aware of these additional events in a timely manner, evaluating whether they are material or reflect financial difficulties, and preparing and filing the required notices, generally within 10 business days of the occurrence of the event. It seems likely that the most important and difficult element of this new, wider inquiry will be setting up processes to ensure that the designated person receives timely notice of the new events that must be disclosed.

Similarly, broker-dealers will need to revise their due diligence processes to devise methods of determining whether any of the new listed events have occurred and, if so, whether they were material or reflect financial difficulties and, if so, were adequately and timely reported to EMMA.

Consider Disclosure Standards Under Federal Securities Laws; and What Must Be Included in an Events Notice. Another critical element that must be borne in mind by borrowers is that the requirements of Rule 10b-5, which requires that disclosure be accurate and complete, will apply to each of the event filings. Thus, simply filing a notice with EMMA that a certain event has occurred may not be sufficient, even if such a notice meets the requirements of the applicable continuing disclosure undertaking. Because many, if not all, of the new proposed events require a certain degree of analysis and context to determine whether they are material or reflect financial difficulties, additional disclosure necessary to provide the context of such a determination is likely to be necessary. Disclosure filed with EMMA is subject to the 10b-5 standard and therefore cannot contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements therein, in light of the circumstances under which it was made, misleading.

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