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SEC Issues New Material Event Notices Under Proposed Rule 15c2-12 Amendments: Holland & Knight

HIGHLIGHTS:

- The U.S. Securities and Exchange Commission (SEC) has proposed adding two additional triggers – in new subparagraphs (15) and (16) – for the material events notice requirements under Rule 15c2-12 (the Proposed Rule).
- According to the SEC, the purpose of the Proposed Rule is to improve investor protection and enhance the financial transparency of municipal bond issuers by improving investor and market participant access to timely information relating to a municipal issuer's financial obligations.
- The Proposed Rule contains two general categories of disclosures. The first relates to disclosures with respect to "financial obligations" (which are broken down into various subcategories) and certain covenants therein. The second relates to defaults, accelerations, terminations and workouts.
- Comments on the Proposed Rule should be submitted to the SEC on or before May 15, 2017.

The U.S. Securities and Exchange Commission (SEC) on March 1, 2017, proposed adding two additional triggers – in new subparagraphs (15) and (16) – for the material events notice requirements under Rule 15c2-12 (the Proposed Rule). At first blush, they seem relatively innocuous. According to the SEC, the Proposed Rule was designed to improve investor protection and enhance the financial transparency of municipal bond issuers by improving investor and market participant access to timely information relating to a municipal issuer's financial obligations.

Early discussions concerning the first section of the Proposed Rule suggested that the intent was to address reporting requirements for bank loans (Direct Placements) incurred by issuers that often were not reported to the secondary market. As noted below, the first section of the Proposed Rule is much broader than that. The second section of the Proposed Rule is intended to require disclosure of defaults, accelerations and terminations that reflect financial difficulty. Specifically, the two new event disclosure requirements contained in the Proposed Rule read as follows:

> (15) Incurrence of a financial obligation of the obligated person1, if material2, or 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
>
> (16) 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.

The rule goes on to define "financial obligations" to mean a:

(i) debt obligation, (ii) lease, (iii) guarantee, (iv) derivative instrument, or (v) monetary obligation resulting from a judicial, administrative, or arbitration proceeding. The term financial obligation shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

In its description of the proposed amendments, the SEC outlines the intent behind the rule changes and provides examples of each category that will be useful in interpreting its intent. Below is a brief summary of the SEC release, which paraphrases a number of the Commission's thoughts with respect to it.

Components of the Proposed Amendments to Rule 15c2-12

As is the case with all existing 15c2-12 reporting events, the obligation of a governmental entity to report the new triggering events comes not as a direct mandate from the SEC to the issuer, but rather as an obligation of the Participating Underwriter to assure that the issuer or "obligated person" agrees to provide the disclosure – usually through the execution of a "continuing disclosure agreement."

The Proposed Rule contains two general categories of disclosures. The first relates to disclosures with respect to "financial obligations" (which are broken down into various subcategories) and certain covenants therein. The second relates to defaults, accelerations, terminations and workouts.

Financial Obligations

As set forth in the definition above, a "financial obligation" can include a debt obligation, lease, guarantee, derivative instrument or monetary obligation resulting from a judicial, administrative or arbitration proceeding. The term "financial obligation" does not, however, include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board (MSRB) consistent with the Rule.

Debt Obligations

The term "debt obligations" seems relatively straightforward and would include any material short- or long-term borrowing by the issuer or obligated person, issued under the terms of an indenture, loan agreement or similar contract that will be repaid over time. The Commission cites as examples a direct purchase of municipal securities by an investor and a direct loan by a bank.

Leases

The term "lease" includes both *operating* or *capital* leases. The Commission cites as an example a lease-purchase agreement to acquire an office building or an operating lease to lease an office building for a stated period of time.

Guarantees

Guarantees were included to capture contingent financial obligations incurred to secure obligations of a third party or obligations of the issuer. The guarantee may assume different forms, including a payment guarantee or other arrangement that could expose the issuer or obligated person to a contingent financial obligation. The Commission cites as an example a county's guarantee of the repayment of municipal securities issued by a town located in the county. The guaranty *may also be of an issuer's own obligations*, for instance, in connection with the issuance of variable rate demand obligations, where the issuer agrees to repurchase, with its own capital, bonds that have been tendered but are unable to be remarketed (where no third-party liquidity facility is provided).

Derivatives

Derivative instruments are intended to capture 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. The Commission cites as an example an interest-rate swap that allows the issuer to fix all or part of its exposure to variable interest rates. The Commission notes that the use of a derivative instrument can also expose the issuer or obligated person to a variety of risks, some of which may be significant.

Judicial, Administrative or Arbitration Proceeding

The Commission included monetary obligations resulting from a judicial, administrative or arbitration proceeding in the proposed definition of "financial obligations" because the requirement to pay such an obligation could adversely impact the issuer's or obligated person's overall creditworthiness and liquidity, and adversely affect security holders. It noted that a settlement order or consent decree that includes a monetary obligation would be included under this proposed definition.

The Commission noted that while information about monetary obligations resulting from judicial, administrative or arbitration proceedings may be publicly available through the media or otherwise, having this information available on MSRB's Electronic Municipal Market Access system (EMMA) would help provide investors and other market participants outside the immediate community with ready and prompt access to this information in an electronic format and in one central location.

Timing of Disclosure

The Commission noted that most event notices would be due in a timely manner not in excess of 10 business days, and that notice of the incurrence of a monetary obligation resulting from a judicial, administrative or arbitration proceeding should be provided within 10 business days of the *initial* imposition of the monetary obligation. This suggests that reporting is required whether or not the matter is subject to appeal.

Covenants and Agreements with Respect to Financial Obligations

The second category of trigger events related to financial obligations under the first Proposed Rule relates to an issuer's agreement to certain contractual terms, including 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."* The Commission seems to be concerned with terms that could result in, among other things, contingent liquidity and credit risks, refinancing risk and reduced security for existing security holders.

Examples of some material terms cited by the Commission are the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates), but the Commission notes that other terms may be appropriate as well, depending on the circumstances.

"Materiality," of course, is the key factor in determining whether a material events notice is required, but what is, in fact, material is not entirely clear. The Commission notes, for example, that an issuer or obligated person may incur a financial obligation for an amount that, absent other circumstances, would not raise the concerns that the Proposed Rule is intended to address. But if an issuer or obligated person agrees to provide a counterparty to a financial obligation with a senior position in the debt payment priority structure, and that agreement affects existing security holders, the event likely does rise to the level of importance that it should be disclosed to investors and other market participants.

Materiality seems to be determined by any event that has a material impact on the entities' liquidity or overall creditworthiness. Here the Commission noted that:

> [T]he increase or change in the issuer's or obligated person's outstanding debt can weaken the measures (e.g., debt service as a percentage of expenditures or debt service coverage ratio) used to assess an issuer's or obligated person's liquidity and creditworthiness and may result in a reevaluation of the issuer's or obligated person's overall credit quality. For example, an increase in outstanding debt could affect an issuer's or obligated person's level of debt service as a percent of expenditures, which industry commenters view as an important indicator of credit quality for general obligation bonds, or such an increase in debt could affect the amount of revenues available to pay debt service for revenue bonds, which is considered in connection with rate covenants or additional bonds tests. If an issuer's or obligated person's liquidity and creditworthiness is impacted, the credit quality of the issuer's or obligated person's outstanding municipal securities could be adversely affected which could impact an investor's investment decision or other market participant's credit analysis.

Timely access to disclosure about a material agreement to covenants, events of default, remedies, priority rights or other similar terms of a financial obligation – any of which affect security holders – could potentially provide important information about the creation of contingent liquidity risk, credit risk and refinancing risk that could impact the issuer's or obligated person's liquidity and overall creditworthiness, and affect security holders' rights to assets or revenues. If an issuer's or obligated person's liquidity and creditworthiness is impacted and/or the rights of security holders are affected, the credit quality and price of the issuer's or obligated person's outstanding municipal securities could be affected.

Other examples cited by the Commission in its release include the following:

- a. financial obligations in which the issuer or obligated person agrees to covenants that are more restrictive than those applicable to the issuer's or obligated person's outstanding municipal securities, such as a requirement to maintain a higher debt service coverage ratio
- b. a more restrictive covenant that would potentially trigger an event of default more easily, and as a result thereof, the counterparty to the financial obligation would be able to assert remedies prior to existing security holders
- c. events of default that differ from those that are applicable to an issuer's or obligated person's outstanding municipal securities, such as a failure to observe any term of the financial obligation (as opposed to specifically identified terms) that would enable the counterparty to the financial obligation to assert remedies prior to existing security holders
  d. the inclusion of different remedies than the issuer or obligated person has provided to existing security holders
- e. the inclusion of an acceleration provision could provide that any unpaid principal becomes immediately due to the counterparty upon the occurrence of a specified event of default, without any grace period, which would effectively prioritize the payment of the financial obligation to the counterparty if the security holders do not have the benefit of the same provision; by agreeing to such a term, the counterparty to the financial obligation could benefit by being repaid prior to

existing security holders

- f. granting material priority rights that provide the counterparty with better terms than existing security holders and, as a result, adversely affect the rights of existing security holders, such as granting superior rights to the counterparty in assets or revenues that were previously pledged to existing security holders and, as a result, reduce security for existing security holders
- g. structuring a debt obligation with a balloon payment that creates a refinancing risk; while this may not be typically identified as a covenant, event of default, remedy or priority right, such a term could potentially impact the issuer's or obligated person's liquidity and overall creditworthiness and adversely affect security holders
- h. imbedding terms in debt obligations and leases, allowing acceleration upon certain trigger events that could become material
- i. providing guarantees and including material terms therein, which affect security holders
- j. including terms in a derivative instrument that may create contingent liquidity risk for the issuer or obligated person, such as a requirement to post collateral or to pay a termination fee upon the occurrence of certain events; thus, the swap itself may not be material based on notional amounts and scheduled payments, but terms such as mark-to-market collateral posting requirements upon a downgrade or above a threshold, the inclusion of additional termination events, or the risk of termination payments upon trigger events controlled by the counterparty could adversely impact the issuer or obligated person's overall liquidity and overall creditworthiness, and thus require disclosure

The Commission notes that there are other material terms similar to covenants, events of default, remedies and priority rights that an issuer or obligated person may agree to that could, among other things, create liquidity, credit or refinancing risks that could affect the liquidity and creditworthiness of an issuer or obligated person, or the terms of the securities they issue.

The Commission notes that by agreeing to a material covenant, event of default or remedy under the terms of a financial obligation, such as the examples provided above, security holders could be affected, and the issuer or obligated person may create contingent liquidity and credit risks that could potentially impact the issuer's or obligated person's liquidity and overall creditworthiness.

Defaults, Accelerations, Terminations and Modification of Terms

The second part of the Proposed Rule in subclause (16) would require an event notice under two scenarios, namely (1) the occurrence of a default, event of acceleration or termination event, and (2) the modification of terms, or other similar events under the terms of a financial obligation of the issuer or obligated person, in each case provided the occurrence reflects financial difficulties. The phrase *"any of which reflect financial difficulties"* applies to all of the events listed in the proposed event notice requirement under subclause (16), i.e., a default, event of acceleration, termination event, modification of terms or other similar events. To clarify the intent, the Commission gave the following examples:

> For example, an issuer or obligated person may covenant to provide the counterparty with notice of change in its address and may not promptly comply with the covenant. A failure to comply with such a covenant may not reflect financial difficulties; therefore, absent other circumstances, this event likely does not raise the concerns the proposed amendments are intended to address. On the other hand an issuer or obligated person could agree to replenish a debt service reserve fund if draws have been made on such fund. In this example, if an issuer or obligated person fails to comply with such covenant, then such an event likely should be disclosed to investors and other market participants.

The Commission notes that a *default* could be a monetary default – in which an issuer or obligated person fails to pay principal, interest or other funds due – or a non-payment-related default, which occurs when the issuer or obligated person fails to comply with specified covenants. Generally, under standard contract terms, if a monetary default occurs or a non-payment-related default *is not cured within a specified period,*3 such default becomes an "event of default" and the trustee or counterparty to the financial obligation may exercise legally available rights and remedies for enforcement, including acceleration.

A *termination event* (typically found under a swap) generally allows either party to a financial obligation to terminate the agreement subject to certain conditions, and in some cases will result in the payment of a termination fee by the issuer or obligated person. Thus the occurrence of a termination event under a derivative instrument may reflect financial difficulties that could adversely impact the issuer's or obligated person's overall creditworthiness.

Modification of Terms

The Commission notes that prior to an event of default or acceleration, a modification of terms of any financial obligation may occur when an issuer or obligated person is in a distressed financial situation. For example, there may be circumstances in which an issuer or obligated person, due to financial difficulties, anticipates not meeting the terms of a financial obligation, such as a covenant to maintain a specified debt service coverage ratio, and the issuer or obligated person is able to negotiate the modification of the terms of the financial obligation with the counterparty. In addition to negotiating a change to certain covenants in the financial obligation with the counterparty, *to avoid default* under the terms of the financial obligation, the issuer or obligated person could agree to new terms, including providing the counterparty with superior rights to assets or revenues that were previously pledged to existing security holders. The Commission notes that disclosure of these modifications could provide important information about the current financial condition of the issuer or obligated person, including potential impacts to the issuer's or obligated person's liquidity and overall creditworthiness, and whether security holders have been affected.

Other Similar Events

The Commission noted that "other similar events" in the Proposed Rule would share similar characteristics to one of the listed events (i.e., a default, event of acceleration, termination event or modification of terms). For instance, an issuer or obligated person could fail to perform a covenant not related to payment required under a financial obligation that does not result in the occurrence of a default, but the occurrence of this other event does reflect financial difficulties of the issuer or obligated person. The Commission provided as an example a situation where an issuer fails to meet a construction deadline with respect to a facility being financed by the proceeds of a financial obligation due to financial difficulties. As a result of the failure to meet this deadline, a default does not occur but the lender is entitled to take possession of the facility and complete construction. The Commission noted that, like other events described above, the occurrence of the failure to meet a performance covenant reflecting financial difficulties, whether or not that failure triggers a "default," could provide information relevant in making an assessment of the current financial condition of the issuer or obligated person, including potential adverse impacts to the issuer's or obligated person's liquidity and overall creditworthiness, and whether security holders have been affected.

The Commission suggested that the event notice for the occurrence of any of these events that reflect financial difficulties generally should include a description of the event and the consequences of the event, if any.

Conclusions

So what should be disclosed under the Proposed Rule? It is likely that issuers will not want to judge the materiality of each event or circumstance described above, or take the time or incur the expense of providing summaries of each new financial obligation. In most instances, then, unless the SEC provides more clarification, it seems likely that issuers will post on EMMA the full text of each applicable agreement. That actually could defeat the purpose of disclosure.

It should be noted that the security for many conduit bonds are structured as general corporate obligations of the obligated person. Thus any subsequent financial obligation for which corporate security is provided could have a material adverse effect on industrial development bonds with respect to which the obligated person is responsible. Given the volume of transactions entered into by a conduit obligated person, particularly with a large corporation, the obligated person probably will be forced to judge materiality so as to avoid continual postings. Perhaps auditors can assist in developing a materiality standard, but even if the size of the financial obligation is otherwise not material, legal review may be required if there is any question as to whether covenants in new financial obligations might be more favorable that those held by existing security holders.

The SEC has requested comments on the Proposed Rule and, to date, a number of comments have been submitted, most of which have requested clarification or safe harbors. For example, Digital Assurance Certification LLC (DAC), an accounting firm and former affiliate of Ernst & Young LLP, in its assessment of the Proposed Rules on March 31, 2017, suggested that:

> "However, unless the SEC's proposal is more sharply targeted, DAC is concerned that the proposal as currently structured would not effectively achieve its stated purpose, would create significant new burdens for issuers, obligated persons and underwriters, and would result in a flow of highly unstructured information into the marketplace that would make it extremely difficult for investors to efficiently identify and assess the items of information that would be relevant to such investors' specific interests in their bond holdings."

DAC then proposed a number of suggestions that would significantly narrow the scope of the Rule, including among other things, tightly defining "financial obligations" and eliminating monetary obligations arising from judgments and other obligations that do not arise from transactions for borrowed money.

Comments on the Proposed Rule should be submitted to the SEC on or before May 15, 2017.

Notes

1 "Obligated Person" under the Rule refers to both the issuer and, in a conduit financing, the underlying obligor. The latter category may become more problematic since corporations and other non-governmental entities will often have much more complex debt, lease, guaranty and derivative structures, all of which would have to be separately analyzed. As used in this report (as was the case in the SEC release), "issuer" and "obligated person" are used somewhat interchangeably and often will include both the governmental entity and, where applicable, the obligated person.

2 "Material" once again is not defined in the Rule although a couple of examples are given. As some commentators have noted, this will no doubt lead to overreporting, and probably increased lawyer costs due to the recent Municipalities Continuing Disclosure Cooperation (MCDC) proceedings. As attorney Paul Maco, a former director of the SEC's Office of Municipal Securities, commented in a

March 9, 2017, article in The Bond Buyer: “Many market participants view the often granular application of materiality displayed in the 71 issuer settlements announced last August as inconsistent with the application of materiality anticipated by experienced municipal finance lawyers, as illustrated by NABL’s August 2014 MCDC Initiative Whitepaper Considerations for Analysis by Issuers of Materiality and Self Reporting and may question how the term will be applied in an enforcement context.”

3 It is not clear whether the Commission is making a distinction between a monetary default, which should trigger a reporting requirement whether or not within a cure period under the loan documents, and a non-payment default, which would trigger a reporting requirement only after the cure period has expired. Because the Commission uses the term “default” and distinguishes that from “acceleration,” it appears that the distinction may be intentional.

by Richard B. “Rick” Stephens, Michael L. “Mike” Wiener and David J. “Dave” Stevens

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Holland & Knight LLP