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Overview Of Continuing Disclosure Requirements For Bond Issuers: Smith Gambrell & Russell

Introduction

Government bodies take on specific obligations to file information regularly (“continuing disclosure”) when they issue bonds through an underwriter. Failure to affirmatively make such filings has significant consequences. These continuing disclosure obligations are the subject of this Overview.

Governmental bonds generally are exempt from the requirements of registration and the filing of periodic disclosure reports under the federal Securities Acts of 1933 and 1934. The exemptions apply both to the governmental bonds of states and local government units, and to “private activity” bonds issued by governmental authorities for the benefit of nonprofit and for-profit companies when the bonds meet the requirements of the Internal Revenue Code for exclusion of interest from federal income taxation. The reason usually stated for these exemptions is that the involvement of the state or local government unit places such securities in a more publicly accessible and more regulated environment than conventional corporate securities.

However, in the mid-1980’s, the Securities and Exchange Commission (“SEC”) adopted Rule 15c2-12 (the “Rule”) in order to regulate and improve the market for securities (generally referred to herein as “Bonds”) issued by state and local governmental bodies (“Governmental Issuers”). The Rule directly regulates only bond underwriters (the parties that purchase Bonds with a view to reselling them), but indirectly requires persons committed to support payment of Bonds (“Obligated Persons”) to make continuing disclosure. Usually the Governmental Issuer is the Obligated Person taking on continuing disclosure obligations, but Obligated Persons can also include others that obtain the benefit of a Bond issue by using the facilities financed and agreeing to pay the Governmental Issuer amounts that will repay the Bonds.

Rule 15c2-12 has two basic elements. First, it requires that a substantially final “preliminary official statement,” providing disclosure of the material information concerning an issuance of Bonds, be reviewed and provided to potential Bond purchasers, and that a final official statement be prepared and made available. Second, the Rule requires that underwriters participating in most Bond offerings obtain from the Governmental Issuer of the Bonds (and/or one or more other Obligated Persons) a written continuing disclosure agreement to provide continuing disclosure with respect to those Bonds. The consequences of this second provision are discussed below.

Continuing Disclosure Obligations Under Rule 15c2-12

Rule 15c2-12 requires that an underwriter, prior to purchasing or selling Bonds in connection with a covered Bond offering, determine that the Governmental Issuer, and/or one or more Obligated Persons for whom financial or operating data is presented in the official statement, has undertaken in writing to provide to every nationally recognized municipal securities information repository (“NRMSIR”) and to the appropriate state information depository (“SID”), if any (there being none in

Georgia and several other states) the following:

- By a specified date, annual financial and operating information for the Governmental Issuer and each other Obligated Person for whom financial information or operating data is presented in the official statement (an “Annual Information Filing”);
- When and if available, audited annual financial statements for Obligated Persons (“Audits”);
- In a timely manner, notice of the occurrence of one of eleven material events described below (a “Material Event Filing”); and
- In a timely manner, notice of a failure of any person required to provide the Annual Information Filing referred to above, on or before the date specified in the continuing disclosure agreement (“Notice of Failure”).

Although the Rule originally stated that a filing will be made with each NRMSIR, procedures have been established for one centralized filing with a “Central Post Office.” Filing can be made by email.

The specific continuing disclosure obligations taken on will be set out in the continuing disclosure agreement. The form of a continuing disclosure agreement is not prescribed by Rule 15c2-12, other than the requirement that it contain undertakings addressing the matters described above. The continuing disclosure agreement usually takes the form of a “continuing disclosure certificate” signed by the Governmental Issuer or other Obligated Person, or a continuing disclosure agreement between the Governmental Issuer or other Obligated Person and the Bond trustee or some other disclosure agent. The continuing disclosure agreement is executed in connection with the preparation for or closing of the Bond issue, and is enforceable against the signing party by the holders of the Bonds. The continuing disclosure agreement will be included in the closing transcript for the issue and typically is made an appendix to or set forth substantially in full in the text of the official statement.

Annual Information Filing and Audit Requirements

Continuing disclosure agreements must address the following requirements for Annual Information Filings and Audits:

- The specific financial information and operating data to be provided;
- What financial statements are to be filed and when;
- In reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited; and
- The date each year by which annual financial information will be provided.

The Rule is quite specific about the undertaking that the party providing disclosure must make, with one significant exception. The Rule does not specify what annual financial information is to be provided in an Annual Information Filing, other than to state that the required information will be set forth in the continuing disclosure agreement and that the information will cover each person obligated for the Bonds for whom financial information or operating data is presented in the official statement. “Annual financial information” is defined as financial information or operating data, provided at least annually, of the type included in the official statement with respect to an Obligated Person.

The apparent intent of this requirement is to cause the Governmental Issuer or other Obligated Person(s) to make annual filing of the information necessary to update and keep current the material information concerning that person (or other persons) set forth in the official statement. However, this intent is not clearly stated in the Rule, and the Obligated Persons and the underwriter can negotiate to determine the content of the continuing disclosure agreement. Annually providing

updates of all information in the official statement could be a considerable task, and arguably some of the information in the official statement, while of some relevance to an investor, is not necessary or even material and can be excluded (for example, the number of bank branches and the number of deposits in a county, items which are typically included in the official statement).

The most usual practice with respect to the contents of Annual Information Filings is to require, in addition to the Obligated Person's annual financial statements, the filing of other annual information necessary to update the significant tables and other disclosure presented in the official statement; for example, the most recent tax levy and collection data pertinent to a tax-backed bond issue.

In fact, there is wide variation in the content required by various continuing disclosure agreements. Some require little or nothing in addition to the information contained in the annual financial statements, and others require information that would appear not to be addressed by the terms of the Rule (for example, information that does not constitute "financial or operating data" of the Obligated Person, such as lists of the ten largest employers in a community).

Because each continuing disclosure agreement constitutes a separate, negotiated obligation enforceable for the life of the relevant Bonds, care should be taken that the continuing disclosure requirements are consistent with respect to timing and content. Otherwise the Obligated Person may be required to make different filings at inconsistent times, or to cumulate the lists of required disclosures from the various agreements.

Financial information or operating data constituting an Annual Information Filing may be contained in a document or set of documents submitted as part of a disclosure filing, or may be included by specific reference to documents previously provided.

Material Event Filings

A continuing disclosure agreement must require a Governmental Issuer or other Obligated Person to give timely notice of the following events with respect to the Bonds being offered, if material:

- Principal and interest payment delinquencies;
- Nonpayment-related defaults;
- Unscheduled draws on debt service reserves reflecting financial difficulties;
- Unscheduled draws on credit enhancements reflecting financial difficulties;
- Substitution of credit or liquidity providers, or their failure to perform;
- Adverse tax opinions or events affecting the tax-exempt status of the Bonds;
- Modifications to rights of bondholders;
- Bond calls;
- Defeasances;
- Release, substitution or sale of property securing repayment of the Bonds;
- Rating changes.

Consequences Of Failure To Make Required Disclosures

There are several consequences to a failure to comply with continuing disclosure obligations:

The continuing disclosure agreement is an enforceable obligation, and the Obligated Person may be compelled, either by the underwriter, by any holder of the Bonds, and sometimes by other persons, to make the disclosure reports called for;

Failure to comply with the continuing disclosure obligations should be disclosed in future official statements;

Failure to comply with continuing disclosure obligations may “chill the market” for the Obligated Person’s Bonds, since the Bond market may feel it cannot rely on that person to comply in the future;

If an aggrieved person could prove a loss arising out of the failure to disclose, an action for damages for breach of contract or securities fraud is a possibility; for example, an investor might assert that he would have sold his Bonds before a decline in their price if missing information had been timely filed; and

The continuing disclosure agreement requires Obligated Persons to file a Notice of Failure to comply.

Exemptions From Continuing Disclosure Requirements

Since Rule 15c2-12 applies to underwriters, it follows that the Rule does not apply to Bonds or other forms of financing placed with a financial institution or investor that is not underwriting the Bonds. This type of financing is commonly known as a “private placement.”

The Rule also does not apply to underwritten limited offerings where the Bonds have authorized denominations of not less than \$100,000, but only in one of three specific types of transactions:

- The Bonds are sold to no more than 35 persons, each of whom the underwriter reasonably believes has knowledge and experience in financial and business matters and that is capable of evaluating the merits and risks of the investment and is not purchasing for more than one account or with a view to distributing the Bonds;
- The Bonds have a maturity of nine months or less; or
- The Bonds are “tender option securities” that may be tendered by the holder back to the Governmental Issuer or its agent at a minimum of par value at least as frequently as every nine months (for example, variable rate demand bonds).

Also, a partial exemption is available to “small issuers,” but this exemption is somewhat illusory. The partial exemption applies if no Obligated Person with respect to the Bond issue is an Obligated Person with respect to more than \$10,000,000 in aggregate principal amount of outstanding Bonds that are subject to the Rule, including the new Bonds to be issued. In such an event, a continuing disclosure agreement, although it must require Material Event Filings be made, need not require Annual Information Filings of financial operating information concerning the Obligated Persons or filings of financial statements with the NRMSIRs. The exemption is somewhat illusory because if it is to be utilized, the official statement must identify by name, address and telephone number the persons with the Governmental Issuer or other Obligated Person from whom the information that otherwise would be included in such an Annual Information Filing can be obtained, and any company or member of the public may demand copies of the financial statements, financial information and operating data as called for in the continuing disclosure agreement. Such financial statements, financial information and operating data must include, at a minimum, those which are customarily prepared by such Obligated Person and are publicly available.

Finally, if Bonds have a stated maturity of 18 months or less, a continuing disclosure agreement need only require that Material Event Filings be made.

Summary

Although the federal securities laws do not directly require Governmental Issuers of Bonds (and the parties that benefit from and support Bonds) to make periodic or other reports of information pertinent to the Bond issue, a similar requirement has been imposed indirectly through the SEC’s Rule 15c2-12. Pursuant to the Rule, Governmental Issuers of Bonds and/or other Obligated Persons

with respect to the Bonds must enter into continuing disclosure agreements specifying the filing and information requirements, unless one of several full or partial exemptions apply. Governmental Issuers and other Obligated Persons need to be acutely aware of the requirements in the agreements for continuing disclosure that they sign in connection with each Bond issue, and with the content and timing of reports they obligate themselves to make. Failure to comply with these continuing disclosure agreements may have serious consequences, as described above.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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