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Securities and Exchange Commission Amends and Updates Rule 15c2-12: K&L Gates

Since 1995, states and local governments have been subject to Rule 15c2-12 (the "Rule"), promulgated by the U.S. Securities and Exchange Commission (the "SEC"). Under the Rule, governmental entities that issued securities (and persons obligated under those securities ("obligated persons")) were required to enter into continuing disclosure agreements (generally referred to as "undertakings"). These undertakings obligated the governmental entity to make regular annual filings of financial information and also to file notices whenever certain "listed events" occurred. The undertakings remained in effect for the entire life of the bond issue or defeasance of the bonds.

In August 2018, the SEC announced an amendment to the Rule. **This amendment will take effect on February 27, 2019.** These amendments have been the topic of substantial public discussion in seminars and written releases in the press and numerous law firm blogs. Regardless of what you have read or heard, however, **this amendment may or <u>may not</u> increase your future financial reporting obligations** or otherwise affect your community. Before you spend a lot of time in seminars or meetings learning about the Rule, consider whether it will have an impact on your public entity/community.

In general, a public entity will not be affected by the changes in the Rule, if:

1. The public entity has no outstanding debt;
2. The public entity's only outstanding debt is in the form of bank loans; or
3. The public entity does have outstanding bond issues (issued prior to February 27, 2019) and the public entity has no expectation of going to the public market with new bond issues in the foreseeable future.

If, however, your community does expect to issue publicly offered bonds in the foreseeable future, then you should understand more about the Rule.

The discussion below provides information to help you understand more about the Rule and the changes incorporated under the Rule's recent amendment and includes information about Government Accounting Standards Board ("GASB") Statement No. 88:

The SEC has indirectly regulated the obligations of states and local governments in the financial markets through its ability to regulate the activities of brokers/dealers in the municipal industry. [1] The Rule was originally promulgated in 1989 by the SEC under authority of the Securities Exchange Act of 1934. The original Rule required that dealers acting as Participating Underwriters in Offerings (an offering of municipal securities by a municipal issuer with an aggregate principal amount of $1,000,000) obtain, review, and distribute to potential customers copies of the issuer's official statement. The Rule was amended in 1994, and this amendment accomplished, albeit indirectly, what the SEC could not do directly. When the SEC adopted paragraph (b)(5) of the Rule, Participating Underwriters could no longer purchase or sell municipal securities unless the issuer

had adopted an undertaking for the issue. With that change, the Rule now imposed regulations on states and their local governments. [2]

Paragraph (b)(5) of the Rule prohibits a Participating Underwriter from purchasing or selling municipal securities covered by the Rule in an Offering unless the Participating Underwriter has reasonably determined that an issuer or obligated person of those municipal securities has undertaken in a continuing disclosure agreement (an "undertaking") to provide specified information to the Municipal Securities Rulemaking Board (MSRB) in an electronic form as prescribed by the MSRB. [3] The information to be provided consists of: (i) certain annual financial and operating information and audited financial statements, if available ("annual filings") [4]; (ii) timely notices of the occurrence of certain events ("event notices") [5]; and (iii) timely notices of the failure of an issuer obligated person to provide required annual financial information on or before the date specified in the continuing disclosure agreement ("failure to file notices"). Event notices are required to be filed within 10 business days of the occurrence of the listed event. [6]

The SEC has been considering expanding the list of the disclosure events for some time. In particular, there has been a focus on the increased number of private placements of bonds and bank loans, as they have not been not subject to the Rule. On August 20, 2018, the SEC released adopted amendments to the Rule. [7] These amendments apply to all undertakings entered into on and after February 27, 2019. From this February date and after, all new undertakings are required to comply with the amended Rule. The amendments added two additional events, expanding the list from 14 to 16 events, in a continuing disclosure undertaking. Future undertakings are required to include the following event notices:

> (15) Incurrence of a material financial obligation of the issuer or obligated person 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; and
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> (16) Default, event of acceleration, termination event, modification of terms or other similar events under the terms of a financial obligation of the issuer or obligated person, any of which reflect financial difficulties.

The amendments define the term "financial obligation" as 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) guarantee of (i) or (ii). The term "financial obligation" does not include any obligation for which a final official statement has been provided to the MSRB. In other words, the issuer does not need to file an event notice for the incurrence of any security that is already disclosed to the market through a final official statement.

Key considerations for the amended Rule include:

1. The amendments are not retroactive.
The amendments do not add any new requirements to issuers' current undertakings. Accordingly, issuers may continue to comply with their existing undertakings in the same manner as they have been filing and posting with EMMA.

2. If a governmental entity enters into an undertaking in the future, that undertaking will include the two additional event notice requirements.
With respect to those new event requirements:

1. The additional disclosure requirement identified in (15) above applies to debt or "debt-like" obligations. The issuer is not required to disclose ordinary operating liabilities.
2. The disclosure requirement identified in (15) only applies to those debt obligations that are "material." The amendments do not define the term "material," and issuers are permitted to make their own determination of what debt obligations are material. On a going-forward basis, issuers may consider developing procedures or protocols for identifying which debt or "debt-like" obligations are material.
3. If an issuer determines that the incurrence of a debt or "debt-like" obligation is material, the notice of the event should include the material terms of the financial obligation. The SEC provided examples of "material terms" as: (i) date of the incurrence, (ii) principal amount, maturity, and amortization; (iii) interest rate (if fixed) or method of computation (if variable) plus any default rates and other depending on the circumstances. Accordingly, the disclosure may be satisfied by filing a term sheet or by filing the entire document.
4. If the issuer enters into a derivative instrument (e.g., swaps and hedges) relating to a municipal security, that transaction must always be disclosed.
5. The additional disclosure requirement identified in (16) above is limited to those occurrences that reflect financial difficulties. For example, if the issuer enters into a loan modification agreement with respect to a loan (regardless of whether the original obligation has previously been disclosed on EMMA), that event would be required to be disclosed in an event notice.

3. GASB Statement No. 88.
The GASB recently issued its Statement No. 88 — Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placement (March 2018), requiring that additional information related to debt be included in audited financial statements. [8]

This requirement is in effect for reporting periods beginning after June 15, 2018. Accordingly, many issuers are likely developing protocols for identifying the types of information that are now required be disclosed under the amendments to the Rule.

Inclusion of this information in an issuer's financial statement will not, however, satisfy the requirements of the Rule, because the Rule will now require that a separate event notice be filed on a timely basis upon the incurrence of each new the debt or "debt-like" obligation (within 10 business days).

Notes

[1] The SEC directly regulates the issuers of corporate securities, primarily to prevent disclosure-related abuses in the corporate securities market, under the authority of the Securities Act of 1933 and the Securities and Exchange Act of 1934 (together, the "Securities Act"). Municipal securities are exempt from registration under Section 3(a)(2) of the Securities Act, but are subject to the Securities Act's anti-fraud provisions. Municipal securities brokers and dealers are also regulated by the SEC and by the MSRB. When drafting the Securities Act, Congress did not have concerns about abuse in the municipal securities market. Since then, perception of abuses in the municipal securities market have increased with the complexity and volume of the market. The Securities Act's provisions are broadly written, and so federal securities anti-fraud law has evolved primarily through the courts. Court decisions have found the anti-fraud provisions applicable in a number of municipal securities transactions, leading to the development of a framework for municipal disclosure responsibilities, driven as well by the MSRB and the Dodd-Frank Act provisions. The SEC's Office of Municipal Securities has initiated enforcement actions against municipal issuers, municipal employees, and other market participants.

[2] See Exchange Act Release No. 34-26985 (June 28, 1989), 54 FR 28799 (July 10, 1989) ("1989

Adopting Release). For additional information relating to the history of the Rule, see Exchange Act Release No. 34-34961 (Nov. 10, 1994), 59 FR 59590 (Nov. 17, 1994) ("1994 Amendments Adopting Release"), Exchange Act Release No. 34-59062 (Dec. 5, 2008), 73 FR 76104 (Dec. 15, 2008) ("2008 Amendments Adopting Release"), and Exchange Act Release No. 34-62184A (May 27, 2010), 75 FR 33100 (June 10, 2010) ("2010 Amendments Adopting Release").

[3] On December 5, 2008, the SEC adopted amendments to the Rule to provide for the Electronic Municipal Market Access ("EMMA") system. EMMA is established and maintained by the MSRB and provides free public access to disclosure documents. The 2008 Amendments designated the EMMA system as the single centralized repository for the electronic collection and availability of continuing disclosure information about municipal securities. The 2008 Amendments require the Participating Underwriter to reasonably determine that the issuer or obligated person has undertaken in its continuing disclosure agreement to provide continuing disclosure documents: (i) solely to the MSRB; and (ii) in an electronic format and accompanied by identifying information, as prescribed by the MSRB. See 2008 Amendments Adopting Release; see also Exchange Act Release No. 34-58255 (July 30, 2008), 73 FR 46138 (Aug. 7, 2008) ("2008 Proposing Release"). The 2008 Amendments became effective on July 1, 2009.

[4] See 17 CFR 240.15c2-12(b)(5)(i)(A) and (B).

[5] See 17 CFR 240.15c2-12(b)(5)(i)(C). Under the Rule prior to these amendments, the following events require notice in a timely manner not in excess of ten business days after the occurrence of the event: (1) principal and interest payment delinquencies; (2) nonpayment related defaults, if material; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting financial difficulties; (5) substitution of credit or liquidity providers, or their failure to perform; (6) adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security; (7) modifications to the rights of security holders, if material; (8) bond calls, if material and tender offers; (9) defeasances; (10) release, substitution, or sale of property securing repayment of the securities, if material; (11) rating changes; (12) bankruptcy, insolvency, receivership or similar event of the obligated person; (13) the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into an agreement relating to any such actions, other than pursuant to its terms, if material; and (14) appointment of a successor or additional trustee or the change of name of a trustee, if material. In addition, Rule 15c2-12(d) provides full and limited exemptions from the requirements of Rule 15c2-12. See 17 CFR 240.15c2-12(d).

[6] See 17 CFR 240.15c2-12(b)(5)(i)(D). Annual filings, event notices and failure to file notices are referred to collectively as "continuing disclosure documents."

[7] See the SEC Report on the Municipal Securities Market, (July 31, 2012) ("2012 Municipal Report"), available at: https://www.sec.gov/news/studies/2012/munireport073112.pdf.

[8] GASB Statement No. 88 is available at: http://www.gasb.org/jsp/GASB/Document_C/Documentage?cid=1176170308047&acceptedDisclaimer=true.

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