

## CML LEARN FROM THE PROS

### Amendments to SEC Rule 15C2-12

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## INTRODUCTION

- Since 2008, the number of state and local governments privately placing bonds and other municipal debt obligations directly with banks has increased.
- SEC is concerned that investors in publicly offered debt do not have adequate or timely information about such privately placed obligations.

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## INTRODUCTION

- In 2018, the SEC adopted amendments to the continuing disclosure provisions of Rule 15c2-12 to address such concern.
- The Amendments took effect on February 27, 2019.

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## RULE 15c2-12 REVIEW

- The Rule prohibits underwriters from purchasing or selling most municipal securities unless an issuer has agreed in writing to provide specified information to the market on an ongoing basis, i.e. continuing disclosure.
  - The written agreement is often referred to as an Undertaking.
- Information to be provided consists of: (i) annual financial information and operating data, (ii) annual audited financial statements; and (iii) timely notice of the occurrence of certain events known as Event Notices.

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## RULE 15c2-12 AMENDMENTS

- Prior to the Amendments, the Rule specified 14 events for which Event Notices are required to be filed.
- The Amendments added two additional events to the Rule.
- The required financial information and Event Notices are provided to the market via the Municipal Securities Rulemaking Board's Electronic Municipal Market Access ("EMMA") system.
  - <https://emma.msrb.org>

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## RULE 15c2-12 AMENDMENTS

- Event 15 requires an Event Notice if the following occurs:
  - (15) Incurrence of a "**financial obligation**" of the obligated person, **if material**, 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**. (emphasis added)

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## RULE 15c2-12 AMENDMENTS

– Event 16 requires an Event Notice if the following occurs:

- (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**.

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## RULE 15c2-12 AMENDMENTS

– The Amendments define “financial obligation” to mean a:

- (A) Debt obligation;
- (B) Derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or
- (C) Guarantee of an obligation or instrument described in paragraph (A) or (B).

The term “financial obligation” does not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule.

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## RULE 15c2-12 AMENDMENTS

– The Rule does not define any of the terms used in the definition of “financial obligation.”

– Adopting release indicates that the term “financial obligation” includes only debt, debt-like, and debt-related obligations.

- A “debt obligation” is a vehicle to borrow money.
- Ordinary financial and operating liabilities incurred in the normal course of an issuer’s business do not constitute “financial obligations.”

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## RULE 15c2-12 AMENDMENTS

– Operating leases (for copiers and other equipment, for instance) should not constitute “debt obligations” regardless of size or duration.

– Lease arrangements that operate as vehicles to borrow money are likely “debt obligations” i.e. certificate of participation transactions, lease-purchase agreements

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## RULE 15c2-12 AMENDMENTS

– The Rule does not define “derivative instrument.”

– The release provides that the term is limited to derivative instruments entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation.

– A derivative instrument could be a swap, futures contract, forward contract, option, or any similar instrument to which an issuer is a counterparty if the instrument is designed to hedge against the risks of a related debt obligation.

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## RULE 15c2-12 AMENDMENTS

– “Materiality” is an elusive concept that is based on the facts and circumstances of a particular scenario.

– Generally, something is material if there is “substantial likelihood that a reasonable security holder would consider the information important in deciding whether to buy or sell a security.”

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## RULE 15c2-12 AMENDMENTS

- If an issuer issues new securities that are subject to the Rule on or after February 27, 2019, the Amendments apply and Event 15 and Event 16 must be included in the related Undertaking.
- After the securities are issued:
  - issuer will be required to disclose any financial obligations specified in Event 15 that are entered into (if they are material),
  - issuer must provide notice of the occurrence of any of the items listed in Event 16 that occur in connection with any of its financial obligations (if they reflect financial difficulties), regardless of when they were issued.

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## RULE 15c2-12 AMENDMENTS

- The Amendments apply only if an issuer enters into an Undertaking on or after February 27, 2019.
- The Amendments do not apply retroactively to Undertakings entered into prior to February 27, 2019.
  - For example, if an issuer entered into Undertakings with respect to bonds issued in 2013 and 2017, the Amendments do not apply to those bonds.

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## RULE 15c2-12 AMENDMENTS

- Example: An issuer entered into a bank loan in 2016. On April 1, 2019, the issuer closes on \$15,000,000 of publicly offered fixed rate bonds and enters into an Undertaking with respect to those bonds. The Undertaking includes Event 15 and Event 16 as required by the Amendments and the issuer now has the contractual obligation to provide Event Notices for those events. In October 2019, the issuer enters into another privately placed bank loan and no Undertaking is required. In June 2019, the issuer forgets to file an insurance certificate with the bank that made the 2016 loan, resulting in a covenant default under the loan agreement. In December 2019, the issuer's largest taxpayer closes and the issuer notifies the banks holding the 2016 loan and the 2019 loan that it will not be able to meet its debt service obligations in the next several years; the issuer and the banks negotiate an extension of the loan terms and a reduction in annual payments.

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## RULE 15c2-12 AMENDMENTS

### Application of the Amendments to the Example:

- After executing the April 2019 Undertaking, Event 15 requires the issuer to disclose any new material financial obligations on EMMA, but the issuer is not required to disclose prior financial obligations. Therefore, the issuer is not required to disclose the 2016 bank loan. However, the issuer must disclose the October 2019 bank loan if it is material.
- Event 16 does not require the issuer to disclose the covenant default, because it does not reflect financial difficulties. However, the issuer likely must disclose the amendments to both loans since the modification of terms reflects financial difficulties.

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## RULE 15c2-12 AMENDMENTS

- For new bond issues, Underwriters will not only review the Undertaking being executed in connection with the new securities to determine compliance with the Amendments, but may also inquire about the issuer's existing "financial obligations" and the material terms of those financial obligations (whether or not they are required to be reported under Event 15).
- Underwriters will likely inquire as to whether the issuer has policies or procedures reasonably designed to comply with the Amendments. If the issuer does not have formal policies and procedures, it should be able to describe the steps it takes to ensure compliance with its Undertakings.

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## RULE 15c2-12 AMENDMENTS

- The Government Finance Officers Association has advised its members as follows:
  - "issuers should also review their debt management and disclosure policies and consider adding new provisions to address the Amendments, including:
  - creating a master list of all current financial obligations including, but not limited to, bank loans, capital leases, derivatives, as well as any guarantees of these types of obligations,
  - developing a system to track any financial difficulties related to these obligations,
  - having a process in place to add new financial obligations, and
  - working with counsel to determine materiality of your financial obligations and when financial difficulties may arise."

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## RULE 15C2-12 AMENDMENTS

- The GFOA guidance regarding the Amendments can be found at <http://www.gfoa.org/new-amendments-sec-rule-15c2-12>
- The MSRB also has resources available for issuers regarding the Amendments.
  - <http://www.msrb.org/~media/Files/Resources/10-Things-to-Know-New-SEC-Rule-15c2-12.ashx>
  - <http://www.msrb.org/EducationCenter/issuers/Disclosing.aspx>
- <https://www.butlersnow.com/2019/02/a-brief-guide-to-the-2018-amendments-to-continuing-disclosure-requirements/>

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QUESTIONS?

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