

# Chapman Client Alert

August 27, 2018

Current Issues Relevant to Our Clients

## SEC Adopts Amendments to Rule 15c2-12

On August 20, 2018, the Securities and Exchange Commission (the “SEC”) issued Release No. 34-83885 (the “Release”) adopting amendments (the “Amendments”) to Rule 15c2-12 (the “Rule”) under the Securities Exchange Act of 1934, as amended. The Amendments add two new events to the list of reportable events for which an issuer or obligated person\* must provide notice to the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access (EMMA) website. Under the Amendments, reportable event disclosures under the Rule will be required for:

- 1) (a) the incurrence of a financial obligation of the obligated person, if material, or  
(b) an 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
- 2) a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of an obligated person, any of which reflect financial difficulties.

The Amendments also add a definition of “financial obligation” to the Rule. The Amendments do not amend any of the existing provisions of the Rule and total approximately eleven lines of new text.

While the text of the Amendments is short, the Amendments have significant implications for obligated persons and underwriters of publicly-offered municipal securities as well as financial institutions that enter into direct purchases, private placements, bank loans, municipal leases, derivatives and other types of financial obligations with obligated persons. The SEC has stated it believes the Amendments will provide investors access to important information relating to obligated persons and enhance transparency in the municipal securities market by increasing the amount of information that is publicly disclosed about material financial obligations incurred by obligated persons.

The Amendments as adopted are substantially the same as proposed by the SEC in March, 2017, with some modifications to address issues raised during the required comment period. See our March 27, 2017 [Client Alert](#) for a summary of the amendments as originally proposed.

The compliance date for the Amendments is 180 days after the Release is published in the Federal Register.

### Background

In the Release, the SEC reiterated that since 2009 the volume of direct purchases of municipal securities and direct loans (“Direct Placements”) has grown as an alternative to publicly-offered municipal securities. However, prior to the Amendments, Direct Placements have been disclosed on the MSRB’s EMMA system by obligated persons only on a voluntary basis. Therefore, the SEC indicated that investors may not have had any access or timely access to disclosure about the incurrence of certain financial obligations, such as Direct Placements, and, to the extent disclosure was available, that disclosure may have lacked material information about the obligations. The SEC further indicated that investors may not have had “any access or timely access” to disclosure of the occurrence of events under Direct Placements that reflect financial difficulties. The SEC adopted the Amendments to address this perceived lack of investor access to material information.

\* The term “obligated person” is used in the Amendments and in this Client Alert to refer to both an issuer of bonds and an “obligated person” under the Rule (e.g., a tax-exempt 501(c)(3) organization).

## The Amendments

Under the Amendments, underwriters are required to reasonably determine that an obligated person has agreed in a written undertaking to provide prompt notice of new financial obligations and their terms, and certain events, if material, under new or pre-existing financial obligations as described above. The Release provides that event disclosures are required for:

- a new financial obligation, if it is “material” (see below for a discussion of materiality considerations),
- any covenants, events of default, remedies, priority rights or similar terms under a new financial obligation which affect the holders of outstanding municipal securities of the obligated person, if material, and
- a default, acceleration, termination, modification of terms or similar event under a new or pre-existing financial obligation which reflects financial difficulties of the obligated person.

Under the Amendments, the term “financial obligation” means:

- a debt obligation,
- a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation, and
- a guarantee of a debt obligation or a derivative.

The terms “debt obligation,” “derivative instrument” and “guarantee” are broadly construed under the Amendments. Consistent with the stated purpose of the Amendments, a “financial obligation” does not include a municipal security that is issued under an official statement that has been posted on EMMA.

In the Release, the SEC provided guidance on the meaning of “financial obligation”:

- a “debt obligation” includes both short-term and long-term debt obligations of an obligated person under the terms of an indenture, loan agreement, lease, or similar contract regardless of the length of the repayment period of the debt obligation,
- leases that “operate as vehicles to borrow money” (*i.e.* financing leases) are debt obligations, but operating leases are not,

- a “derivative instrument” includes a swap, a security-based swap, a futures contract, a forward contract, an option or similar instrument (or combination) to which an obligated person is a counterparty,
- a “guarantee” includes any guarantee provided by an obligated person (as a guarantor) for the benefit of itself or a third party, which guarantees payment of a financial obligation,
- the materiality of a financial obligation or its terms is determined under general securities law standards (*i.e.*, would the information be important to a reasonable investor in making an investment decision?), particularly with regard to any rights given to the holder of the financial obligation that are prior to the rights of the holders of the obligated persons outstanding municipal securities,
- the material terms of a financial obligation that should be disclosed include the following:
  - date incurred,
  - principal amount,
  - maturity dates and amortization,
  - interest rate, if fixed, or method of computation, if variable, and default rates, and
  - such other terms as are appropriate under the circumstances,
- a default, acceleration, termination, modification or similar event under a financial obligation “reflects financial difficulties” of an obligated person and should be reported if the information is relevant to investors in making an assessment of the current financial condition of the obligated person, and
- the term “default” includes both payment and non-payment defaults, but distinguishes between those that do not reflect financial difficulties (such as failure to provide timely notice of a change in address) and those that do (such as a failure to replenish a debt service reserve fund).

## Considerations for Market Participants

As described above, the additional events provided in the Amendments will now be added to the continuing disclosure undertaking delivered by the obligated person in a primary offering of municipal securities in order for an underwriter to meet its obligations under the Rule. As with the fourteen

existing reportable events, notice of the new reportable events must be given promptly and not later than ten business days of the occurrence of the event.

### Disclosure of New Financial Obligations

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The Amendments could apply to any number of documents and agreements which could potentially be considered financial obligations requiring disclosure, if material. Accordingly, an obligated person will first have to determine if a new contract or agreement is a financial obligation for purposes of the Amendments and, if so, will then have to determine whether that financial obligation is material. While numerous comment letters requested guidance on the materiality standards that should be applied under the Amendments, the SEC declined to provide any new guidance, reiterating its previous statements that “materiality determinations should be based on whether the information would be important to the total mix of information made available to the reasonable investor.”

If a particular contract or agreement is determined to be a financial obligation that is material to investors, an obligated person is then required to make a separate materiality determination regarding which terms and conditions of the financial obligation require disclosure. The Release and the text of the Amendments make it clear that the SEC views any terms of a financial obligation that give its holder preferential or priority rights over the obligated person’s publicly-held bonds as material information that must be disclosed. The final determination an obligated person will need to make with respect to the disclosure of a new financial obligation is whether to disclose its material terms in summary form or by posting the entire contract or agreement to EMMA. In this regard, the SEC stated that an agreement that is posted to EMMA may be redacted to exclude confidential information such as contact information, account numbers and other personally-identifiable information, but did not indicate that commercially-sensitive information (such as the interest rate or interest rate spread under a Direct Placement) could be redacted if that information is material to investors.

When entering into a financial obligation, the obligated person and, in some circumstances, the other party (e.g., a lender, lessor, swap provider, vendor, counterparty or other financial institution) will need to consider whether the material terms of a material financial obligation should be summarized in the reportable event filing or whether copies of the transaction documents (with permitted redactions) should be posted to EMMA. If the material terms of the transaction are to be summarized, the obligated person will need to ensure that the summaries are accurate and complete.

### Disclosure of Defaults and Other Events

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Under the Amendments, obligated persons are further required to disclose defaults, accelerations, terminations and other adverse events under both new and pre-existing financial obligations, if the event “reflects financial difficulties” of the obligated person. The SEC stated in the Release that whether a particular event constitutes a “default” or an “event of default” under a financial obligation is not determinative as to whether disclosure is required, and stated its belief that “there are defaults that may reflect financial difficulties even if they do not qualify as ‘events of default’ under transaction documents.”

The “reflecting financial difficulties” concept is embedded in the existing reportable events under the Rule for unscheduled draws on debt service reserves and credit enhancement facilities. The SEC stated in the Release that this concept is intended to “target the disclosure of information relevant to investors in making an assessment of the current financial condition of the issuer or obligated person.” Accordingly, obligated persons will need to make a further determination as to whether a default or other adverse event under, or a modification of the terms of, a financial obligation reflect financial difficulties such that disclosure is required in a reportable event notice.

Modifications and waivers of terms of a financial obligation provided by lenders to obligated persons raise particular concerns and questions. For example, if an obligated person is unable to meet a particularly strict financial covenant and the lender agrees to waive the covenant because other financial ratios and covenants meet their lending guidelines, the obligated person will need to make a determination as to whether this type of waiver should be disclosed. Under these circumstances or similar situations, it is possible that a lender will hesitate to accommodate obligated persons (whether the obligated person is financially sound or in financial distress) if the obligated person is required or advised to disclose the full details of the waiver or accommodation.

### Considerations for Obligated Persons

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The multiple determinations required to be made by an obligated person under the Amendments discussed above will present a range of challenges. Whether a particular financial obligation, its terms or an event under a financial obligation is “material” is a mixed question of law and fact. The obligated person will need to determine the personnel who are authorized and qualified to make these determinations, and consultation with legal counsel or a municipal advisor may be necessary. Obligated persons with municipal securities disclosure policies and procedures should review them for updating in light of the Amendments, and obligated persons

without disclosure policies and procedures should give consideration to developing and implementing them. Additional training of the personnel that will make disclosure determinations and formulate the actual text of the required disclosures for an obligated person should also be considered, particularly with regard to materiality considerations. Some obligated persons may have agreed in existing continuing disclosure undertakings to comply with the Rule as it may be amended from time to time. In these cases, the existing undertakings should be reviewed to determine if amendments are required to include the Amendments or if the Amendments are automatically included by the terms of the existing undertakings.

### Considerations for Underwriters

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The Amendments require underwriters to perform additional due diligence with respect to an obligated person's compliance with the Amendments. An underwriter will need to make a determination as to the universe of instruments that could constitute financial obligations that it will request from the obligated person when performing its due diligence. Among other things, an underwriter will need to make its own determinations with respect to whether a particular instrument is a financial obligation, whether it is a material obligation and which of its terms are material to investors. Further, an underwriter will need to make determinations as to whether the occurrence of certain events under the terms of a financial obligation of an obligated person reflect financial difficulties. These determinations will require additional time, and

underwriters will need to ensure that they begin their financial obligation review early in the due diligence process.

Given the lack of any bright-line standards regarding materiality, it is entirely possible that an underwriter's determinations with respect to financial obligation disclosure may be different from those previously made by an obligated person. In these circumstances, the parties may need to also determine whether a remedial reportable event filing needs to be posted on EMMA, and whether disclosure needs to be made in the official statement with respect to the obligated person's failure to timely file a reportable event notice when the financial obligation was incurred.

### Timing of Application of Amendments

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Compliance with the Amendments is required for continuing disclosure undertakings that are entered into in connection with primary offerings of municipal securities that close on or after 180 days after the Amendments are published in the Federal Register.

The SEC press release dated August 20, 2018, is available [here](#) and Release NO. 34-83885 is available [here](#).

### For More Information

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If you would like further information concerning the matters discussed in this Client Alert, please contact a member of the Public Finance Group or visit us online at [chapman.com](http://chapman.com).

## Chapman and Cutler LLP

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