



## SEC Rule 15c2-12

NAVIGATING THE NEW CONTINUING  
DISCLOSURE REQUIREMENTS



STIFEL



The U.S. Securities and Exchange Commission (SEC) has made significant changes to its Rule 15c2-12. The changes will apply to continuing disclosure agreements executed on or after February 27, 2019. This booklet describes the changes to the rule and how issuers can prepare themselves before the changes take effect. In the case of conduit issues, the effect of the rule changes would likely be felt by the conduit borrower rather than the issuer.

## What does the current rule require?

Currently, unless an exemption applies, Rule 15c2-12 requires an underwriter (defined to include a placement agent) to review an issuer's continuing disclosure agreement to make sure it complies with the rule before the underwriter can purchase bonds in a primary offering (or bid for the bonds in a competitive underwriting). The continuing disclosure agreement must require the issuer to update annually the financial information in the official statement (whether or not material), file annual audited financial statements (when and if available), and to provide notices of 14 events within 10 business days after the events occur. Among the 14 listed events are changes in ratings on the bonds and draws on debt service reserve funds reflecting financial difficulties. All of these filings must be made to the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system (EMMA).

## What are the exemptions from Rule 15c2-12?

When any one of the following exemptions to Rule 15c2-12 applies, there is no requirement for an official statement or a continuing disclosure agreement.

- The aggregate principal amount of the issue is less than \$1,000,000.
- The authorized denominations are at least \$100,000, and the issue is sold to no more than 35 financially sophisticated investors purchasing for their own accounts.

- The authorized denominations are at least \$100,000, and the issue has a maturity not exceeding nine months.

There are also partial exemptions for issues with an issuer aggregate principal amount not exceeding \$10,000,000 or with maturities not exceeding 18 months.

## What are the changes?

The SEC's recent amendments to Rule 15c2-12 make two significant additions to the list of events for which notice is to be provided by issuers to EMMA within 10 business days.

- The incurrence by the issuer on or after the date of the new continuing disclosure agreement of:
  - ▶ A material financial obligation, or
  - ▶ An agreement to any of the following, any of which affect security holders, if material:
    - Covenants,
    - Events of default (regardless of whether they have arisen to the level of events of default under financing documents),
    - Remedies,
    - Priority rights, or
    - Other similar terms of a financial obligation;

and

- The occurrence, on or after the date of the new continuing disclosure agreement, of any of the following related to a financial obligation which reflect financial difficulties, regardless of when the financial obligation was incurred:

- ▶ Default,
- ▶ Event of acceleration,
- ▶ Termination event,
- ▶ Modification of terms, or
- ▶ Other similar events.

## What is a “financial obligation”?

The term “financial obligation” is defined to mean:

- 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; or
- A guarantee of a debt obligation or derivative instrument.

## Are there exceptions from the definition of “financial obligation”?

- Importantly, the term “financial obligation” does not include municipal securities as to which a final official statement has been provided to EMMA consistent with 15c2-12, regardless of whether the official statement (OS) filing is required under 15c2-12 or is done on a voluntary basis. In order for this exemption to apply, the issuer will need to enter into a continuing disclosure agreement as well.
- Also, the definition of the term “financial obligation” does not include ordinary financial and operating liabilities incurred in the normal course of business by an issuer, but rather only an issuer’s debt, debt-like, and debt-related obligations.

## What is a “debt obligation”?

In its Adopting Release, the SEC has provided considerable detail on the meanings of key terms. For example, the term “debt obligation” is broad in scope and is not limited by state law definitions of debt. In essence, debt obligations are vehicles for borrowing money, regardless of what they are called (for example, there is no carve out for “loans”). As the SEC puts it, the term “debt obligation” includes short-term and long-term debt obligations under the terms of an indenture, loan agreement, lease, or similar contract, regardless of the length of the debt obligation’s repayment period. A “similar contract” could, for example, include a line of credit obtained from a bank or other lender. Issuers may wish to consult with their accountants to determine whether other obligations may be considered debt for accounting purposes.

## What kind of leases are considered debt obligations?

The types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificates of participation transactions. Examples of leases that are typically not vehicles to borrow money that are common among issuers include, but are not limited to: commercial office building leases, airline and concessionaire leases at airport facilities, and computer and copy machine leases. Although the Governmental Accounting Standards Board (GASB) no longer uses the terms “capital leases” and “operating leases,” that prior distinction may be a useful way to think of the distinction between leases that are debt-like and those that are not.

## What factors determine whether a financial obligation is material?

The SEC has identified the following factors, but there may be others:

- Source of security pledged for repayment of the financial obligation,
- Rights associated with such a pledge (e.g., senior versus subordinate),
- Principal amount or notional amount (in the case of a derivative instrument or guarantee of a derivative instrument),
- Covenants,
- Events of default,
- Remedies,
- Other similar terms that affect security holders to which the issuer agreed at the time of incurrence,
- Size of the overall balance sheet,
- Size of existing obligations, and
- Size of the overall bond portfolio.

## What if there is a series of transactions? Do they need to be aggregated to determine whether they are material?

Materiality is determined upon the incurrence of each distinct financial obligation. If an issuer enters into a series of transactions that, though related, are incurred at different points in time for legitimate business purposes, e.g., to satisfy the bank-qualified bond rules of the IRS, the financial obligations would not need to be aggregated to assess their materiality. The Adopting Release refers to IRS regulations on



the definition of “issue” and the IRS regulations on abusive transactions as examples of when transactions might need to be aggregated to assess materiality.

## **Financial obligations are required to be reported when they are “incurred.” What does that mean?**

A financial obligation generally should be considered to be incurred when it is enforceable against an issuer. The SEC provides as an example that, if an issuer enters into an agreement providing for a drawdown bond, the issuer generally should provide notice to EMMA at the time the terms of the obligation are legally enforceable against the issuer, instead of each time a draw is made.

## **What kinds of derivatives are considered “financial obligations”?**

The definition of “derivative” used in the amendments is intended to include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument to which an issuer is a counterparty provided that such instruments are related to an existing or “planned debt obligation.” This includes, under certain circumstances, instruments that are related to an existing or “planned debt obligation” of a third party.

## **What are some examples of when guarantees of debt obligations would need to be disclosed?**

The SEC has said that both the guarantor and the beneficiary of the guarantee might need to

disclose the guarantee. Self-liquidity for variable rate demand obligations (VRDOs) is an example of a guarantee that would need to be reported.

## **Do the changes to Rule 15c2-12 impose any new obligations on underwriters?**

Not technically, but the changes increase the amount of due diligence that will be required of underwriters. The SEC has stated that underwriters must have a reasonable basis for belief in the accuracy and completeness of an issuer's official statement description of their ongoing continuing disclosure duties. Many underwriters use third-party vendors to prepare reports on their issuer clients' previous continuing disclosure compliance to help the underwriters assess the likelihood of future compliance. That process works well with respect to audited financial statements and annual financial information filings. It also works well for rating changes. Information about those things is easily accessible. Underwriters typically supplement those third-party reports by asking their clients whether any of the other 14 events has occurred. For example, has there been an unscheduled draw on the debt reserve fund reflecting financial difficulties? This process is not likely to work as well for "financial obligations" that are already in place, which are not currently required to be filed with EMMA. Underwriters will need to find some other way to assess whether their clients will comply with their post-February 26, 2019, continuing disclosure agreements. We suggest some ways below for issuers to speed the underwriter due diligence process along and minimize financing delays.

## What can you do to speed the due diligence process for your bond issues that are expected to close on or after February 27, 2019?

An important way to speed the due diligence process is for you, as an issuer, to develop and implement policies and procedures that address how you will do the following on an ongoing basis. This will be particularly important when you have a significant number of financial obligations and compliance with their terms is not centralized. We note that the Governmental Finance Officers Association (GFOA) “recommends that finance officers responsible for their government’s debt management program adopt a thorough continuing disclosure policy.”

- Catalogue your existing “financial obligations.” This may entail reaching out to other departments within your government.
- Create summaries of the existing terms of those financial obligations, including the following:
  - ▶ Date of incurrence
  - ▶ Principal amount
  - ▶ Maturity
  - ▶ Amortization
  - ▶ Interest rate, if fixed
  - ▶ Method of calculation of interest rate, if variable
  - ▶ Any default rates
  - ▶ Security

- ▶ Key covenants
  - Events of default
  - Events of acceleration
  - Termination events
  - Most favored nation clauses (i.e., clauses permitting the purchaser to obtain the benefit of more favorable covenants negotiated with other purchasers)
  - Gross-up provisions
- Assess what “financial obligations” you consider to be material and memorialize that analysis.
- Determine who will be charged with monitoring whether:
  - ▶ You have incurred any new material financial obligations;
  - ▶ Whether you have agreed to any of the following with respect to a financial obligation, any of which affect security holders, if material:
    - Covenants,
    - Events of default (regardless of whether they have arisen to the level of events of default under financing documents),
    - Remedies,
    - Priority rights, or
    - Other similar terms; and
  - ▶ Whether any of the following events has occurred with respect to a financial obligation and whether that occurrence “reflects financial difficulties”:
    - Default,
    - Event of acceleration,

- Termination event,
  - Modification of terms, or
  - Other similar events.
- What will be the process for reporting the incurrence of a new material financial obligation and any of the above events reflecting financial difficulties to EMMA within 10 business days after incurrence? The summary of terms described above may be used to report the incurrence of a new financial obligation to EMMA. If no summary is prepared, the entire financing document with material terms unredacted must be filed with EMMA.

## **What else might underwriters request?**

The SEC has told underwriters that they must independently diligence issuer representations in their official statements, including representations about continuing disclosure. It is likely that underwriters will want to assess whether any material financial obligations that are not in your catalogue of financial obligations have been incurred. In addition to reviewing the most recent audited financial statements and any unaudited financial statements, underwriters may request the agendas for meetings of the governing body since the date of the most recent audited financial statements to determine whether the incurrence of any financial obligations was considered by the governing body. Having those readily available will be helpful, both in preparing your catalogue of financial obligations and to the underwriter in its due diligence.

Stifel looks forward to working with you to make implementation of these rule changes as manageable as possible. The key is starting early by understanding the rule changes and developing a thoughtful process that is tailored to your needs. We stand ready to work with you, as well as your municipal advisor, if applicable, and your bond counsel, to address the many questions that undoubtedly will arise.

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