KUTAKROCK

December 11, 2018

SEC Rule – 15c2-12 Amendments and Implementation

On August 20, 2018, the SEC adopted amendments to Rule 15c2-12. The Amendments add two more types of "events" to be reported by issuers or obligated parties. Although the amendments only need to be included in continuing disclosure undertakings executed with respect to bonds offered on or after February 27, 2019, because these new events are broad-reaching and subjective, they will require issuers to have established in advance internal procedures to regularly collect information about a much broader range of financial obligations (including currently existing obligations), and then assess whether any of such information must be reported to EMMA. And this collection/assessment/reporting must occur within 10 business days of the relevant triggering action. Moreover, in some cases the triggering action is not the kind of simple, objective event specified in the present 15c2-12 reporting events.

In light of the extensive broadening of the Rule 15c2-12 events, issuers should consider the following steps to proactively prepare to comply with the changes. And it is strongly recommended that issuers not wait until the last minute to start thinking about these expanded responsibilities and how to respond institutionally.

First Step

An issuer should be sure it understands what the two additional "events" mean. The specific provisions are:

- 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 *[added as paragraph (b)(5)(i)(C)(15) of the Rule]*; and

- 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 *[added as paragraph (b)(5)(i)(C)(16) of the Rule]*.

Attached is a more detailed discussion of the meaning of certain terms, and nuances and ambiguities, of these provisions. The SEC has publicly stated that these provisions are subject to interpretation and judgment, and, as always, the application of these provisions is based on the specific facts and circumstances of the situation. And the SEC said it does not intend to provide any more specific interpretive guidance (at least, not before the first enforcement action)! So decisions such as what is a "financial obligation" and whether an event is "material" to investors or reflects "financial difficulties" are left to the issuer (and its advisors).

Second Step

An issuer needs to assess its present procedures and internal financial data collection and monitoring system. In particular:

(1) What type of information needs to be collected to comply with the new Amendments, and does the type of information presently collected need to be broadened?

For example, does an issuer presently collect information on all its debt obligations? What is "material" for the organization (or, if it's not clear what general standards would apply, who will make that decision)? What would be a "financial difficulty"? Is the information the issuer collects and monitors sufficiently detailed to identify any "default," whether or not it constitutes a document "event of default"?

(2) Who in the organization is responsible to collect and report such information? Does that group need to be broadened to meet the broadened reach of the new Amendments? Does the group need training about their responsibilities?

(3) Who is responsible for assessing whether an event meets the subjective tests of the new Amendments? Does the issuer have systems allowing information and issues to be presented to decision-makers on a timely basis? Remember, the issuer only has 10 business days to report an event on EMMA.

(4) How are future financial obligations (or amendments to or waivers of terms in existing contracts) to be reported and analyzed regarding whether they should be included in the institutional data base and/or made the subject of an EMMA report, or to support decisions made?

(5) Is there a need to create a new data base reflecting decisions regarding the new events (the SEC clearly recommends such a data base) or to create a new set of objective standards to record precedents and provide guidance for future decisions?

Third Step

An issuer will need to review, and quite possibly update, its policies and procedures to reflect the new events. Issuers should expect that in future "due diligence" sessions underwriters will ask if issuers have updated policies and procedures in place. Unlike the present 15c2-12 events – which are generally objective and can be checked by an underwriter analyst or even the DAC computer – these new events are potentially subjective and in many cases not readily visible to persons outside the issuer's organization. As a result, underwriters (and probably the SEC, if and when it gets more active in this regard) will expect more of, and shift more responsibility to, the issuer. The SEC has noted that it may expect underwriters to review the debt obligations listed in the issuer's most recent audited financials and use those as a guide to review the issuer's EMMA filings; hence issuers may need to be more proactive with their auditors with regard to what debts will be listed in year-end financials.

We stand ready to assist with any of the foregoing that an issuer considers appropriate.

December 1, 2018

15c2-12 Amendments – Terms and Nuances

<u>What is a "financial obligation"?</u>

The Amendments define a "financial obligation" as "(i) a debt obligation, (ii) 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 (iii) a guarantee of (i) or (ii)." However, the term does not include "municipal debt obligations" for which a final official statement has been filed with EMMA consistent with the requirements set forth in Rule 15c2-12 (this exclusion does not extend to instruments or obligations related to the municipal securities). But --- this exception is not as broad as it appears, as it only applies to municipal securities for which an official statement is required to be filed. For example, if bonds are issued and a swap is described in the official statement which is filed with EMMA, the official statement filing requirement only pertains to the bonds, not the swap, so technically the swap may have to be the subject of a separate EMMA event filing.

The term "debt obligation" becomes a key component of determining what instruments are covered by the Amendments. A "debt obligation" includes any short-term or long-term debt obligation under the terms of an indenture, loan agreement or similar contract that will be repaid over time. That is, any obligation that is effectively a "borrowing." So a bank loan to an issuer, or a bank direct purchase of a bond, clearly is a "debt obligation."

Leases that are entered into as a vehicle to borrow money are included as a "debt obligation." This would include "lease purchase" or "lease revenue" financings, including lease "certificates of participation." Often called "financing leases." Typically in such lease transactions, upon the final scheduled payment, title to the leased property passes to the governmental lessee for a nominal sum (such as $1), not for the then fair market value of the property. Such leases are to be distinguished from so-called "true leases," where the leased property is expected to have significant residual value and is expected to revert to the lessor upon termination of the lease. A 5 or 10 year lease of office space with no right to purchase would be a classic example of a "true lease" not subject to the Amendments. As would a 3 year car lease. In any case, the substance of a lease transaction is determinative, not its label.

A "financial obligation" does not include a monetary obligation resulting from a judicial, administrative or arbitration proceeding. (This is a change from the proposed Amendments.)

Likewise, a financial obligation does not include ordinary financial and operating liabilities incurred in the normal course of business, such as utility bills, copier rentals, cleaning contracts, etc.

Derivative instruments include swaps, security-based swaps, futures contracts, forward contracts, options, any combination of the foregoing, or any similar instrument to which an issuer is a counterparty. But <u>only if</u> entered into in connection with, or pledged as security or a source of payment for, an existing or <u>planned</u> debt obligation. So a swap tax reallocation from one bond issue to another would not be included so long as both issues are in the same indenture/resolution. Also, derivative instruments designed to <u>mitigate investment risk</u> for an issuer would not be included.

A debt obligation is "planned" if, based on the facts and circumstance when it is entered into, a reasonable person would view it as likely or probable that the issuer will incur the related, but not yet incurred, debt obligation at a future date. For example, if the derivative is effectively "triggered" by the to-be-issued debt, serves no economic purpose without the to-be-issued debt, the derivative documents contemplate the future debt, the issuer's governing body has taken any action to authorize the future debt, or the issuer has hired professionals to assist in the future debt.

A "guaranty" is also covered by the Amendments if it is a guaranty of a "debt obligation" or "derivative" as described above. Such a guaranty is covered whether for the benefit of the issuer itself or a third party. This includes those cases in which the issuer is the guarantor, and may also include a guaranty where the issuer is the beneficiary of a guaranty (and the guaranty is a material term of the guaranteed underlying debt obligation or derivative).

<u>What does "material" mean?</u>

The SEC explains that the classic definition of "materiality" applies. That is, would the financial obligation (or its terms) be important to a reasonable investor when making an investment decision. There are various terms which courts have generally determined are "material" – such as principal amounts, interest rates, redemption provisions, security for repayment and costs of issuance/underwriter's compensation. Often issuers have little or no basis to independently determine what is important to a "reasonable investor"; ideally the professionals who interact with investors (e.g., underwriters, or even financial advisors) can provide guidance. However, given current regulatory pressure on underwriters, they are probably going to be inclined to view more events as "material" – and SEC spokespersons have clearly endorsed a broad interpretation for EMMA reporting purposes. Which may create some tension in due diligence sessions.

Also, even though independently not material, a series of transactions may collectively be material. The Amendments' Commentary suggests, as an example, that the IRS rules for tax treatment as a single issue (transactions sold within 15 days and as a common plan of finance with common security) is a guide to the aggregation of a series of transactions.

The Commentary also provides examples of the type of debt terms which may well be material (disclosable), such as the date of incurrence of the debt, principal amount, maturity and amortization, and interest rate (fixed, or method of computation if variable). Also, tax-related provisions, such as tax-change or make-up provisions.

A debt obligation is "incurred" when it is enforceable against an issuer. For example, in the case of a draw down obligation, the debt is incurred when the instrument is signed – not when draws are made. And in the case of a forward delivery contract, when the contract is signed and not the date of delivery; the same with respect to a forward starting swap.

<u>Agreement to Covenants, Event of Default, Remedies, Priority Rights or Similar Terms</u>

Examples of such agreements would generally include standby bond purchase agreements (i.e., liquidity agreements) or continuing covenant agreements (often used in direct bank bond purchases) if (as is often the case) such agreements give the counterparty bank acceleration or mandatory redemption rights, or possibly even term out rights, that are more favorable than those afforded other counterparties or bondholders.

<u>What is a "default"? Or a modification of terms?</u>

The Commentary makes it clear that a "default" does <u>not</u> mean an "event of default" under a financial obligation contract. Probably because documents often provide that an event has a cure period or notice requirement before it becomes an "event of default." Rather, the broader, simple term "default" is used in the Amendments, which could be a failure to pay or a failure to comply with specified covenants, even though the debt obligation itself provides for a grace period or requires notice for the "default" to mature into an "event of default."

Likewise, a "modification of terms" is to be broadly read. It includes not only written modifications, but also such things as a verbal waiver of the terms or requirements of an agreement.

“Reflecting Financial Difficulties”

Unfortunately, the “default, acceleration, termination or modification event” provision of the Amendment isn’t subject to a “materiality” test. However, the additional condition to the reporting event – “reflecting financial difficulties” – ameliorates the effect of events involving many routine administrative acts, such as a bond trustee’s waiver of a 30-day notice for a bond redemption, or a late filing of a routine budget or an investment notice.

Conduit Issues

Issuers of conduit debt should closely review the continuing disclosure agreements (CDAs) and any obligations they may have thereunder. In most conduit issues the borrower is the only obligated party; the issuer is not. Only an obligated party need report. Sometimes an issuer is an obligated (reporting) party for limited events – if so, any new CDAs need to be carefully drafted in light of the Amendments lest the issuer inadvertently assume reporting responsibility for events solely within the purview of the borrower (e.g., “debt obligation” events, especially anything reflecting financial difficulties).

February 27, 2019 Compliance Date

The Amendments apply to CDAs executed in conjunction with “offerings” that occur on or after Wednesday, February 27, 2019, but not until such offerings actually occur. For example, if (on or after February 27, 2019) an issuer first offers bonds in June, 2019, the issuer will only have to start reporting on new Amendments events which occur on or after the related CDA is executed in June. On a slightly different note, if a preliminary official statement is distributed before February 27 but the bonds are offered/sold on or after February 27, the CDA description in the preliminary official statement preferably should include the events in the Amendments as the events would be in the executed CDA.