Chapman and Cutler LLP

Chapman Client Alert

March 27, 2017 Current Issues Relevant to Our Clients

SEC Issues Proposal to Amend Rule 15c2-12

On March 1, 2017, the Securities and Exchange Commission (*"SEC"*) issued a release (the *"Release"*) seeking comments on proposed amendments (the *"Proposed Amendments"*) to Rule 15c2-12 (the *"Rule"*) under the Securities Exchange Act of 1934, as amended. The proposal seeks to amend the list of reportable events for which an issuer* must provide notice to the Municipal Securities Rulemaking Board (the *"MSRB"*). Under the Proposed Amendments, disclosure would be required for the following additional events:

1) 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; and

2) 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.

The Proposed Amendments have implications for issuers and underwriters of publicly-offered municipal securities as well as financial institutions that enter into direct purchases, private placements, bank loans, municipal leases and other types of financial obligations with issuers of publicly-offered municipal securities. The SEC has stated it believes the Proposed Amendments will provide investors access to important information relating to issuers and enhance transparency in the municipal securities market.

Background

In the Release, the SEC acknowledged that since 2009 the volume of direct purchases of municipal securities and direct loans *("Direct Placements"*) has grown as alternatives to publicly-offered municipal securities. However, Direct Placements are disclosed on the MSRB's Electronic Municipal Access System *("EMMA"*) by issuers of publicly-offered municipal securities only on a voluntary basis. Therefore, the SEC indicated that investors may not have "any access or timely access to disclosure about the incurrence of certain debt obligations, such as direct placements," and, to the extent disclosure is available, it may lack material information about the obligations. The SEC further indicated that investors may not have "any access or timely access" to disclosure of the occurrence of events reflecting financial difficulties. The SEC released the Proposed Amendments to address this perceived lack of access to material information.

The Proposed Amendments

Incurrence of Financial Obligation or Agreement to Covenants

Under the Proposed Amendments, from and after the effective date of the Proposed Amendments, an underwriter would need to reasonably determine that an issuer has agreed in its continuing disclosure agreement to provide notice of the "incurrence of a financial obligation of the [issuer], if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the [issuer], any of which affect security holders, if material." The SEC identified the terms described in the preceding sentence because if those terms are included in the financial obligation, they may be more restrictive than the covenants set forth in the agreements pertaining to the existing securities, with the potential to trigger a default that permits the holder of

* In this Client Alert, "issuer" also refers to an "obligated person" under the Rule (e.g. a tax-exempt 501(c)(3) organization) and these terms are used interchangeably.

that financial obligation to assert remedies prior to existing securities holders.

For purposes of the Proposed Amendments, the term "financial obligation" means a debt obligation, lease, guarantee, derivative instrument, or monetary obligation resulting from a judicial, administrative, or arbitration proceeding.

In the Release, the SEC provides guidance on the meaning of various proposed terms used within the definition of "financial obligation" as follows:

- "debt obligation" is intended to capture short-term and long-term debt obligations of an issuer under the terms of an indenture, loan agreement, or similar contract that will be repaid over time.
- "lease" is intended to capture a lease that is entered into by an issuer, including an operating or capital lease.
- "guarantee" is intended to capture contingent financial obligations of the issuer to secure obligations of a third party (e.g. [a] county guaranteeing repayment of debt of a town) or obligations of the issuer (e.g. an issuer paying tender price for its bonds that are not remarketed upon a tender).
- "derivative instrument" is intended to capture 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.

The SEC further clarified that the materiality determination applies to the incurrence of a financial obligation as well as each of the enumerated terms, such as covenants, events of default, remedies, priority of rights, or other similar terms.

The SEC also provided guidance that a description of the material terms of a financial obligation should be included in an event notice and provided examples of some possible material terms, such as the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable, and default rates as well as other terms appropriate under the circumstances.

Events Under Financial Obligation Reflecting Financial Difficulties

Under the Proposed Amendments, from and after the effective date of the Proposed Amendment, an issuer in its continuing disclosure agreement would be required to provide notice of a "default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the [issuer], any of which reflect financial difficulties."

The SEC stated that it believes that modifying the list of reportable events with the phrase "any of which reflect financial difficulties" strikes an appropriate balance and that this modifier applies to all of the events listed in the proposed event. The SEC guidance draws a distinction between covenants that are not intended to be covered (such as failure to provide a change in address in a timely manner) and covenants that are intended to be covered (such as replenishment of a debt service reserve fund and the failure to do so).

The Release states that the occurrence of a default, including a payment default or a non-monetary default which becomes an event of default, and an event of acceleration are included because they provide information about the financial condition of the issuer and could adversely affect an issuer's liquidity and overall creditworthiness. Also, a termination event under an agreement may require an issuer to pay a termination fee that may increase its outstanding debt or reduce funds available to pay debt service on existing securities and therefore have an immediate impact on the issuer's liquidity or overall creditworthiness. It is not clear whether this proposed event notice as to an issuer's "financial difficulties" is limited to difficulties with respect to the source of funds expected to pay the securities to which the continuing disclosure agreement relates, or is intended to relate to the issuer's general creditworthiness.

With respect to modifications of the terms of financial obligations, the SEC observes that an issuer that does not expect to fulfill a financial covenant such as a debt service coverage ratio may negotiate a modification of the terms of a financial obligation with a counterparty and, in doing so, may avoid a default or may change the covenants which may include new terms or superior rights, and disclosure of these modifications may provide important information to investors about the current financial condition of the issuer and whether existing security holders have been affected.

With respect to other similar events that would trigger the notice requirement, the SEC notes that similar events reflecting financial difficulties may share similar characteristics with a default, acceleration, termination event or modification, and states that failure to perform a covenant under a financial obligation may not result in a default but the occurrence of that event may reflect financial difficulties of the issuer. The SEC provides the example of an issuer failing to meet a construction deadline with respect to facilities being financed with a financial obligation due to financial difficulties, which failure was not a default but entitled the lender to take possession of the facility and complete the project.

Possible Implications

As described above, the additional events provided in the Proposed Amendments would be added to the continuing disclosure undertaking delivered by the issuer in a primary offering of municipal securities in order for an underwriter to meet its obligations under the Rule. As with events currently described in the Rule, upon the occurrence of an event described in the Proposed Amendments, an issuer will be required to file an event notice within ten business days of the occurrence of the event.

The Proposed Amendments could apply to any number of documents and agreements which could potentially be considered financial obligations requiring disclosure, if material. Neither the Proposed Amendments nor the Rule provide a definition for "materiality," so issuers will have to determine if a contract, agreement or obligation resulting from a judicial, administrative or arbitration proceeding is a financial obligation for purposes of the Proposed Amendments and, if so, whether that financial obligation is material. If material, then an issuer is required to determine which terms and conditions warrant disclosure and whether those terms will be disclosed in summary form or by posting the entire agreement to EMMA. Depending on the issuer and its business activities, determining whether certain contracts, agreements, leases or obligations resulting from judicial, arbitration or administrative proceedings are financial obligations could become an operational issue for the issuer. The issuer will need to determine the personnel who are authorized and qualified to make these determinations and file event notices in a timely fashion. The issuer may need to consult with outside counsel or its municipal advisor when making these determinations.

The Proposed Amendments raise questions for underwriters with respect to due diligence of an issuer's compliance with the Proposed Amendments. Each underwriter will need to make a determination as to the universe of financial obligations that it will request from the issuer when performing its due diligence. Additionally, when entering into a financial obligation, the issuer and 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 the financial obligation are summarized or whether full copies of the documents are posted to EMMA and, if the terms are summarized, who will incur the costs to ensure the summaries are accurate and complete.

In addition, the application of the Proposed Amendments to the concepts of defaults, modification of terms and similar events reflecting financial difficulties could present a challenge when analyzing whether such an event presents financial difficulties requiring disclosure. Modifications and waivers of terms of a financial obligation provided by lenders to issuers raise particular concerns and questions. For example, if an issuer 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 issuer 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 issuers (whether the issuer is financially sound or in financial distress) if the issuer is required or advised to disclose the full details of the waiver or accommodation.

Timing of Application of Proposed Amendments

The Proposed Amendments are expected to be effective approximately three months after the SEC receives comments and issues the final version of the Proposed Amendments and, based on current guidance from the SEC, any amendments will be prospective and apply only to primary offerings following the effective date of any final rules.

SEC Seeks Comment

The SEC is encouraging comments from industry participants on the Proposed Amendments and has asked for feedback on certain specified topics. Some of those topics are summarized below:

- Frequency of the occurrence of the events described in the Proposed Amendments and utility of the information to investors and other market participants in the secondary market.
- What occurrences should trigger the obligation to provide the event notice?
- Should any or all of the items included in the text of the rule be excluded from the materiality condition?
- Should the SEC provide additional guidance on the types of information issuers should consider in drafting notices?
- Are the proposed definitions appropriate in the context of the kind of disclosure the SEC intends to elicit?
- Is the qualification "reflecting financial difficulties" appropriate and, if so, should the SEC provide guidance regarding the use of this concept for purposes of the Proposed Amendments? Should this qualifier be excluded from certain events in the related rule text?
- Commenters are asked to address the benefits and costs of each portion of the Proposed Amendments.

Please see the Release for the full scope of the questions with respect to which the SEC is seeking comment.

Issuers, underwriters and financial institutions or other entities who may be a party to a financial obligation with an issuer are encouraged to review the Proposed Amendments to determine the effects and potential unintended consequences that the Proposed Amendments may have, or burden they may place, on their respective businesses and operations and provide comments to the SEC.

Comments on the Proposed Amendments must be submitted by May 15, 2017. Comments may be sent to rule-comments@sec.gov or submitted electronically here.

For More Information

If you would like further information concerning the matters discussed in this article, please contact your primary Chapman attorney or visit us online at chapman.com.

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