Strafford

Presenting a live 90-minute webinar with interactive Q&A

New SEC Disclosure Obligations for Municipal Bond Issuers

Material Events, Continuing Disclosure Agreements, Implications of Voluntary Postings

THURSDAY, MARCH 21, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Robert Feyer, Senior Counsel, **Orrick Herrington & Sutcliffe**, San Francisco

Elaine C. Greenberg, Shareholder, **Greenberg Traurig**, Washington, D.C.

Heidi H. Jeffery, Partner, **Foley & Lardner**, Chicago

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-869-6667** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

March 2019

New SEC Disclosure Obligations for Municipal Bonds

Robert Feyer
bobfeyer@orrick.com

Elaine C. Greenberg
greenberge@gtlaw.com

Heidi H. Jeffery
hjeffery@foley.com

Agenda

- Municipal bond continuing disclosure requirements before 2018 SEC amendments
- SEC enforcement actions and MCDC
- SEC background on new events
- New "events" that trigger disclosure
- Best practices to avoid violations/How to Prepare
- Implications of voluntary postings
- Hypotheticals
- Q&A

Municipal Bond Continuing Disclosure Requirements Before 2018 SEC Amendments

- Rule 15c2-12 under the Exchange Act indirectly regulates municipal securities offerings by directly regulating the actions of underwriters
- The Rule requires an underwriter, prior to bidding for, purchasing, or selling a primary offering of municipal securities, to:
  - Obtain and review a "deemed final" official statement; and
  - Reasonably determine that an issuer, or obligated person, has undertaken in a written agreement or contract for the benefit of holders of the securities, to provide the MSRB with certain specified continuing disclosures, including annual financial information, and notices of certain events.

Municipal Bond Continuing Disclosure Requirements Before 2018 SEC Amendments

- Rule 15c2-12(b)(5)(i)(A)
- (i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities Rulemaking Board, either directly or indirectly through an indenture trustee or a designated agent:
- (A) Annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

Municipal Bond Continuing Disclosure Requirements Before 2018 SEC Amendments

- Rule 15c2-12(b)(5)(i)(C)(1)-(14)
- (C)In a timely manner not in excess of ten business days after the occurrence of the event, notice of any of the following events with respect to the securities being offered in the Offering:
- (1) Principal and interest payment delinquencies;
- (2) Non-payment related defaults, if material;
- (3) Unscheduled draws on debt service reserves reflecting financial difficulties;
- (3) Unscheduled draws on debt service reserves reflecting financial difficulties;
- (4) Unscheduled draws on credit enhancements reflecting financial difficulties;
- (5) Substitution of credit or liquidity providers, or their failure to perform;
- (6) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security;
- (7) Modifications to rights of security holders, if material;

Municipal Bond Continuing Disclosure Requirements Before 2018 SEC Amendments (cont.)

- (8) Bond calls, if material, and tender offers;
- (9) Defeasances;
- (10) Release, substitution, or sale of property securing repayment of the securities, if material;
- (11) Rating changes;
- (12) Bankruptcy, insolvency, receivership or similar event of the obligated person;
- (13) The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and
- (14) Appointment of a successor or additional trustee or the change of name of a trustee, if material.

Municipal Bond Continuing Disclosure Requirements Before 2018 SEC Amendments

- Notices of these events must be made in a timely manner not in excess of ten business days after the occurrence of the event
- Rule 15c2-12(f)(3) also states that the final official statement has to set forth:
  - A description of the continuing disclosure undertakings
  - A description of any instances in the previous five years in which the issuer failed to comply, in all material respects, with any previous continuing disclosure undertaking

SEC Enforcement Actions

Case on Continuing Disclosure

West Clark Community Schools, IN and City Securities Corporation

- In the summer of 2013, the SEC settled an antifraud case against a small school district in Indiana which stated in its OS that it had not failed to comply in all material respects with any prior disclosure undertakings, but had in fact failed to file any annual reports; SEC alleged this misstatement in the OS was a violation of Section 17(a)(2) of 1933 Act
- The SEC utilized its antifraud enforcement power over issuer
- Underwriter paid a $580,000 settlement (disgorgement and penalty) for failing to investigate the issuer's OS statement; and the individual at the underwriter paid approximately $38,475 (disgorgement and penalty) with a one year collateral bar and a permanent supervisory bar
- This case led to SEC's MCDC Program

MCDC Program

- On March 10, 2014, SEC announced the MCDC Initiative to encourage municipal issuers and underwriters to voluntarily self-report materially inaccurate statements made in bond offering documents regarding prior compliance with continuing disclosure obligations under Rule 15c2-12
- Deadline for underwriters was September 10, 2014 and deadline for issuers was December 1, 2014
- In exchange for self-reporting, more favorable and standardized settlement terms would be given to issuers and underwriters
- SEC would not recommend civil penalties for issuers participating in the MCDC Initiative and would agree to a set civil penalty schedule for participating underwriters based on the size of the offering and the amount of the underwriter's total revenue and capped at $500,000

MCDC Program

- SEC warned that those issuers and underwriters not participating in the MCDC Initiative, but who are responsible for materially inaccurate statements concerning prior disclosures, may be subject to increased sanctions
- In particular, SEC stated that it will likely seek financial sanctions against issuers and the financial sanctions against underwriters will likely be greater than the ones set forth in the MCDC Initiative
- MCDC Initiative only covered issuers and underwriters
- Did not cover individuals associated with those entities
- SEC stated it may recommend enforcement action against individuals and may seek remedies beyond those available through the MCDC Initiative, even if the entities participated in the initiative
- Determinations regarding individual liability will be made on a case-by-case basis, assessing all facts and circumstances, including evidence of intent and other factors, including cooperation

MCDC Program

- Settled enforcement actions
  - Underwriters
    - Three separate waves
    - 72 firms
    - SEC noted: Approximately 96% of market share for municipal underwritings
  - Issuers
    - One wave
    - 71 issuers and obligated persons

MCDC Program

KEY FACTS—ISSUER SETTLEMENTS

- Issuers included: states, counties, cities, school districts, airport authorities, sanitary districts, fire protection district, power agency, housing authorities
- Obligated Persons included: universities, hospitals, college foundation, retirement residence, health care corporation, waste management company

MCDC Program

KEY FACTS—ISSUER SETTLEMENTS

- Misleading statements in OSs about compliance
- No statement in situations of non-compliance
- Failure to file audited financial statements

MCDC Program

KEY FACTS—ISSUER SETTLEMENTS

- Failure to file financial information / operating data
- Material event notice (defeasance)
- Look-back period: cited 2012 and 2014 OSs that did not mention failure to file 2009 audits

MCDC Program

SETTLEMENT TERMS FOR ISSUERS

- Establish appropriate continuing disclosure policies and procedures
- Training regarding continuing disclosure obligations
- Comply with existing continuing disclosure undertakings
- Including updating past delinquent filings
- All within 180 days of the settlement order

MCDC Program

SETTLEMENT TERMS FOR ISSUERS

- Cooperate with subsequent investigation by SEC's Division of Enforcement regarding the misleading statements, including roles of individuals or other parties
- Disclose in a clear and conspicuous fashion settlement terms in official statement for offering by issuer within five years of settlement order
- Provide to SEC staff a compliance certification regarding the applicable undertakings by the issuer on the one-year anniversary of settlement order
- No civil penalty

MCDC Program

SETTLEMENT TERMS FOR UNDERWRITERS

- Civil Penalties—$20,000 per offering for offerings of $3 million or less; $60,000 per offering for larger offerings (caps from $100,000 to $500,000 depending on firm's 2013 revenues)
- Retain independent consultants, not unacceptable to the commission staff, to conduct compliance reviews, make recommendations regarding due diligence process, procedures, and enact the recommendations (subject to appeal to SEC staff)
- Cooperate in subsequent investigations
- Certify compliance on one-year anniversary

Recent SEC Enforcement Actions

Post-MCDC SEC cases on Continuing Disclosure

City of Beaumont, CA (2017) – Beaumont Financing Authority ("BFA") issued approximately $260 million in municipal bonds in 24 separate offerings from 2003 to 2013, each underwritten by O'Connor & Company Securities, Inc. ("O'Connor"). From 2004 to April 2013, BFA regularly failed to provide investors with the promised information (in a complete and timely manner) and failed to disclose this fact when it issued bonds in 2012. BFA and O'Connor didn't voluntarily report to SEC under MCDC. O'Connor was found to have failed to conduct reasonable due diligence on CDA compliance. The sanctions were more severe than under MCDC. The SEC went beyond the MCDC settlements by including individual issuer officers and by requiring that BFA engage an independent consultant.

Significant because (i) BFA required to hire independent consultant on securities procedures and (ii) individual official (city manager) was fined $37,500 and agreed to a permanent injunction against participating in any municipal securities offering. O'Connor was fined $150,000 and was ordered to retain a consultant. It's investment banker was ordered to pay a $15,000 penalty and serve a six month suspension from the securities industry.

Recent SEC Enforcement Actions

Lawson Financial Corp (2017) – Lawson Financial Corporation ("Lawson Financial") was the underwriter for multiple issues for entities controlled by Richard Brogdon ("Brogdon"), the proceeds of which were to be used for projects for nursing homes, assisted living facilities and retirement housing. The offering documents represented that the borrowers had not failed to comply with any prior CDAs, when in fact they had consistently failed to provide the required information. The SEC found that Lawson Financial conducted inadequate due diligence, did not review EMMA, and solely relied on Brodgen's representations. Lawson Financial and Robert Lawson paid disgorgement of approximately $198,000, Lawson Financial paid a penalty of approximately $198,000, and Robert Lawson paid a penalty of $80,000 and was barred from the securities industry for three years. The SEC separately charged Brogdon with fraud and is seeking an order for Brogdon to repay $85 million to investors. Not reported under MCDC.

Significant because it was found that underwriter failed in its role as gatekeeper to conduct reasonable due diligence.

Background on New Events (2017 Release)

Commission Report on the Municipal Securities Market – July 2012

Two Key Areas of Concern: Disclosure and Market Structure

Consideration of Further Amendments to the Rule to mandate more specific secondary market event disclosures, including disclosure relating to new indebtedness, regardless of whether such debt is subject to the Rule or arises as a result of a municipal securities issuance.

Noted concerns about the absence of proper disclosure of the existence or terms of bank loans, particularly when the terms may affect the payment priority from revenues in a way that adversely affects public bondholders.

Market Developments

Increasing use of direct placements as alternatives to public offerings of municipal securities and related calls from market participants/industry groups (rating agencies, FINRA, MSRB, GFOA, NFMA, etc.) for voluntary disclosure.

Amendments designed to increase information available to investors to make more informed investment decisions.

Timeline of Amendments to Rule 15c2-12

- **March 1, 2017**: SEC publishes for comment proposed amendments to Exchange Act Rule 15c2-12 (the "Rule")
- **May 15, 2017**: Deadline for comments on proposed amendments
  - About 90 comments were filed
  - 18 months of review and consideration followed
- **August 20, 2018**: SEC announces adoption of revised amendments to the Rule
- **August 31, 2018**: Amendments published in federal register
- **February 27, 2019**: Compliance date for the amendments
  - Any new Continuing Disclosure Agreement ("CDA") executed on or after February 27, 2019 (the "Compliance Date") must include the new events

Focus and Purpose of Amendments

- According to SEC news release, the adopted amendments "focus on material financial obligations that could impact an issuer's *liquidity, overall creditworthiness, or an existing security holder's rights*"
- Better inform investors and market participants about financial condition of issuers of municipal securities and obligated persons
  - Timely information about "financial obligations"
- Link to the final rule as published in the Federal Register: https://www.sec.gov/rules/final/2018/34-83885.pdf
- Two new Events discussed further

New Events

New "Listed Events" adopted by SEC (emphasis added)

(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*

(16) default, event of acceleration, termination event, modification of terms or other similar events under a financial obligation of the obligated person, any of which *reflect financial difficulties*

Note that event (15) comprises two separate clauses, so that in reality the new Rule amendments require giving notice of three different types of events.

New Events (cont.)

There is no obligation to make reports until an issuer or obligor sells new debt to the public markets after the Compliance Date, with a CDA. Smaller or infrequent issuers or obligors, or those which do not use the public debt markets, may not have to be concerned with this new Rule for some time, if at all.

The new events **do not apply** retroactively to CDA's in existence prior to the Compliance Date.

New Events (cont.)

New Defined Term – "Financial Obligation"

"Financial Obligation" is defined as a: (i) debt obligation; (ii) 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 either (i) or (ii).

- According to the Release, the term focuses on debt, debt-like or debt-related obligations of issuers/obligated persons
- The term specifically *excludes* municipal securities as to which "a final official statement has been provided to the MSRB consistent with the Rule"

What is a "Financial Obligation"

"Debt Obligation": any short-term or long-term debt obligation under the terms of an indenture, loan agreement, lease or similar contract which represents a borrowing of money to be repaid at a later date.

- Focus on obligations and terms that could adversely affect rights of existing security holders or impact the liquidity or creditworthiness of an issuer or obligated person
    - Events of default, acceleration rights
- The term is broader than state law definition of debt. Not limited to general obligation or *ad valorem* tax debt. Includes revenue transactions and subject to appropriation financings
- Examples: direct purchases, private placements, direct loans, commercial paper and leases that operate as vehicles for borrowed money
- The SEC Release states that the definition excludes ordinary financial and operating liabilities incurred in the normal course of business.
    - However, this is more in the nature of a conclusion about arrangements which are not "debt-like" than a part of the definition.

Leases

- One of the more controversial parts of the amended Rule is the handling of leases.
- The Proposed Amendments in 2017 would have included all leases as a category of “financial obligation.” In eliminating this item from the definition, the SEC Release nonetheless stated that leases which acted as a means of borrowing money were a sub-category of a “debt obligation.”
- The analysis is based on economic substance, not state law.
- Clearest example of a lease as a debt is a certificate of participation financing or lease-revenue bond financing where the lease payments support or are the debt sold to investors.

Leases

- SEC staff have used the following example: A city leases new police cars from a local dealership. There may or may not be a purchase option. As there is no visible borrowing of money by the city, just a lease of an asset, this is not a financial obligation. Alternatively, the city may arrange funding with a lease financing entity, which acquires the police cars from the dealer and leases them to the city. The city's rental payments repay the financing and the city takes title at the end of the lease. This would be a "debt-like" obligation.
- Because GASB 87 has eliminated the prior definitions of a "capital lease" and an "operating lease," the SEC decided not to use those terms in the Release, but the prior concepts can be a useful starting point.
- Similar analysis needs to be applied to other kinds of contractual arrangements. Look for some arrangement which could be characterized as a borrowing involving the issuer or obligor.
- Until more definitive guidance is given, counsel dealing with more ambiguous situations will have to make its best effort to analyze the facts and circumstances.

Other Obligations

- Line of Credit or Letter of Credit Reimbursement Agreements likely are financial obligations. In addition to reporting the incurrence of such an obligation, may also have to report the application of special conditions such as a term-out which accelerates repayment and/or increases interest rate as an event under (16).

Financial Obligation (cont.)

"Financial Obligation" is defined as a: (i) debt obligation; **(ii) 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 either (i) or (ii)

- Any swap, security-based swap, futures contract, forward contract, option or similar instrument (or combination) to which an issuer or obligated person is a counterparty
- Focus on exposure to contingent liquidity risk (e.g. collateral postings and termination payments) which could adversely impact liquidity or creditworthiness or affect interests of security holders
- "Planned" – At the time the issuer or obligated person incurs the related derivative, would a reasonable person view it likely or probable that the issuer or obligated person will incur the related debt obligation at a future date?
  - Based on objective assessment of facts and circumstances
  - Relevant factors include documents evidencing assumptions about future debt, preliminary or final actions authorizing debt obligation and hiring of professionals to assist with debt issuance
- Does not cover derivative instruments designed to mitigate investment risk or not related to a particular debt issue

Financial Obligation (cont.)

Reporting requirement applies to any guarantee of a debt obligation or of a derivative instrument related to an existing or planned debt obligation. May trigger two reporting requirements:

- When an issuer or obligated person acts as a guarantor for the payment of a debt or derivative, it must be reported, if material; and
- When an issuer or obligated person is the beneficiary of a guarantee of a third party relating to a financial obligation, may be reportable as a material term of the debt or derivative
- If a VRDO financing is excluded from being a “financial obligation” because it has an official statement posted to EMMA consistent with the Rule, but the conduit borrower uses self-liquidity for unremarketed put bonds, is this a separate security which should be reported (since it is not a municipal security)?

Financial Obligation (cont.)

"Financial Obligation" does not include municipal securities as to which "a final official statement has been provided to the MSRB consistent with the Rule."

- This exception was added in order to avoid duplication of regulatory requirements. The normal publicly-offered bond issue has its OS posted on EMMA and is subject to a CDA which will provide investors with annual financial information and notice of the 14 events existing under the Rule as of 2010. New events (15) and (16) are not needed to inform the holders of these securities of developments relating to them.
- An issuer or obligor may have outstanding (or future) bond financings which are partially or wholly exempted from Rule 15c2-12. In some cases, nonetheless, an OS has been or can be posted voluntarily to EMMA. Initial reaction to the amendments was that this step alone would exempt this bond from (15) and (16).
- In public conferences, SEC staff has stated that this is an incorrect interpretation of the words "consistent with the Rule." In order for a financing which is otherwise exempted to avoid having to be reportable as a "financial obligation" there must not only be an OS posted to EMMA but the issuer or obligor must also have entered into a CDA compliant with the Rule – it must agree to make annual financial reports and report on the 16 events.

Financial Obligation (cont.)

- This exclusion covers only the municipal securities and does not extend to instruments or obligations (contingent or otherwise) related to the municipal securities
- In the CDA, the issuer or obligated person is still required to make related disclosures under new (15) and (16) with respect to any such instruments or obligations (e.g. any derivatives or guarantees)

Breaking Down New Event (15)

(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*

Scope of Event Reporting: Under CDAs entered on or after the Compliance Date, clause 1 applies to new, material financial obligations incurred on and after the date the CDA was entered, i.e. clause 1 is prospective only.

Clause 2 applies to new, material agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation agreed to by the issuer, whether that obligation was incurred *after or before* the obligor's first CDA after February 27, 2019.

The test for either clause 1 or clause 2 is whether the new obligation or agreement may affect security holders of debt to which the CDA relates.

Breaking Down New Event (15) (cont.)

Incurrence of Financial Obligation: A Financial Obligation generally should be considered to be incurred when it is enforceable against an issuer or obligated person.

- Disclosure will provide investors with important information about current financial condition and potential liabilities, including potential impacts to the liquidity and overall creditworthiness of the issuer or obligated person or which may otherwise affect security holders of the debt to which the CDA relates
- Bonds are incurred when issued, not when sold.
- For programs like a draw down bond, line of credit or commercial paper, the debt is incurred when it is legally in place, even if no funds are immediately drawn down. Once reported, no reports have to made on each individual draw on the facility.

Agreement to Covenants, etc.

- The second clause of event (15) refers to changes made to a financial obligation after it has been issued. It appears to mean a change to the material terms of an obligation voluntarily agreed to by the issuer and the lender. It apparently does not include changes to terms which are embedded in the original loan document, such as a change in interest rate derived from a change in the issuer's rating, or in the tax rate applicable to the lender.
- The financial obligations covered by the second clause of event (15) include those which were entered into *before or after* the signing of the CDA which first added event (15).

Breaking Down New Event (15) (cont.)

Materiality – Materiality qualifier has appeared in the Rule since it was amended in 1994

- Qualifier operates as a framework for issuers and obligated persons to assess their disclosure obligations in the context of the specific facts and circumstances
- Not every incurrence of a financial obligation or agreement to terms is material
- Materiality determinations under either clause of event (15) should be based on whether the information would be important to the total mix of information made available to the reasonable investor – compliance with the new event requirements will be evaluated using the "total mix" of information available
  - Consider potential impacts on the issuer's liquidity or creditworthiness or the rights of security holders
- Determination of whether to file a notice under (15) requires the same analysis regularly made by parties when preparing offering documents

Breaking Down New Event (15)-Materiality (cont.)

- *What is the impact of "materiality" qualifier as used in the first new event*
- Materiality always is challenging and events based
- This qualification ideally would limit the amount of disclosure that must be provided only to events where there is a substantial likelihood that a reasonable investor would consider such information important in making an investment decision, based on the *Basic v. Levinson* standard of materiality
- For a financial obligation to be reported under either clause of event (15) it must be *both* material and affect security holders of the issue to which the relevant CDA relates.
- An important question is whether actions covered by (15) or (16) under a CDA for one particular credit (e.g. a general obligation bond) have to be reported under a CDA for a separate credit (e.g. an enterprise revenue bond)? There is no direct guidance on this question in the Release. While in many cases the separation of the credits would not require a "cross-report," best practice is to examine the facts carefully to ensure the investors of the "other" credit would not be impacted.

Breaking Down New Event (15)-Materiality (cont.)

- As was evidenced by the SEC's recent Municipal Securities Disclosure Cooperation ("MCDC") initiative, there is a lack of clear guidance regarding what is material to an investor in the municipal market
- Previously has lead to a conservative view of materiality and what one market participant has termed "hyper disclosure"
- Determining which events are "material" to a reasonable investor could be difficult and, if the SEC does not later concur with the issuer's or obligor's analysis, the consequences can be severe

Breaking Down New Event (15)-Materiality (cont.)

- In practice, issuers and obligors, particularly larger ones with more complex operations, will need to make an internal decision on what threshold to use for a material obligation. Issuers can consider a variety of factors to assess whether a new, nonpublic obligation is material: percentage of general fund revenue; percentage of debt portfolio; debt service on new debt as percentage of revenues or existing debt service.
- However this determination is made, it is important to develop a clear basis, commit it to writing (likely as part of overall procedures and policies) and indicate which officials signed off on it. Also it should be reviewed regularly for changes in conditions which might indicate a change in the materiality threshold. Existence of such a document can be important in answering inquiries from underwriters or the SEC. These parties should be willing to accept a reasonable test which was carefully developed.

Breaking Down New Event (15)-Materiality (cont.)

- Use of the materiality standard (without further guidance) to qualify the events that must be disclosed gives rise to the concern that issuers and obligors will be required to provide detailed summaries of its direct placements, leases, or swaps, for example, or to post in full redacted copies of the underlying documentation, in order to comply with the Rule
- Thus, an extremely wide range of obligations, if material, will need to be disclosed to EMMA by issuers and obligors

Breaking Down New Event (15) (cont.)

- The Commission adopted a narrower definition of "financial obligation" than it originally proposed, which it expects will reduce the burden on issuers, obligated persons and dealers
- Issuers/Obligated Persons should memorialize materiality analysis when making a decision not to disclose an event under (15)

Timing – Event Notices must be filed within ten business days of date the "financial obligation" is incurred.

- Series of Financial Obligations – consider all relevant facts and circumstances
  - Shared authorizing document; same/similar purpose; same source of security
  - Obligations do not have to be combined if there is a legitimate business reason to separate them (e.g., tax rule for separate issues)

Breaking Down New Event (16)

(16) default, event of acceleration, termination event, modification of terms, or other similar events under a financial obligation of the obligated person, any of which *reflect financial difficulties*

Scope of Event Reporting: An event that occurs under the terms of a financial obligation pursuant to (16) that occurs on or after the date of the first CDA following the Compliance Date must be disclosed regardless of whether such financial obligation was incurred *before or after* the relevant CDA date (similar to event (15) clause 2)

The second added event of the amendments would require an issuer or obligor to provide timely notice of any of the following events: “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”

Breaking Down New Event (16) (cont.)

"Reflect Financial Difficulties" – concept used since adoption of the Rule; existing disclosure events including unscheduled draws on debt service reserves (3) and unscheduled draws on credit enhancements (4)

- As used in connection with new events, concept covers a broad potential series of actions and implies an element of materiality
- Analysis for reporting (similar to event (15)), consider whether the event may have potential adverse impact on the liquidity and overall creditworthiness of the issuer/obligated person or affect security holders
- As with event (15), the event must affect security holders of the issue for which the CDA was entered. When there are multiple credits, careful analysis is needed.

Default – can be monetary default (failure to pay principal/interest or other funds due) or failure to comply with specific covenants; does not have to be an "event of default" as defined in bond documents

"Other Similar Events" – broad concept to capture circumstances that reflect financial difficulties even if they do not qualify under any of the prior types of events

Breaking Down New Event (16)-Financial Difficulties

- One of the themes of the Release and relating to the second new event is that the timing of such financial difficulties disclosure under current law is often delayed because it is included in an annual filing, or such disclosure, if provided, lacks detail
- Amendments seek to address those two issues (timing and detail)

Breaking Down New Event (16)-Financial Difficulties (cont.)

- In the Release, the SEC first notes that the qualifying trigger that any of the events must "reflect financial difficulties" should allow issuers and obligors to distinguish between events that do not reflect financial difficulties (such as failure to comply with a covenant to provide notice of a change of address) compared to the failure to replenish a debt service reserve fund
- The former is unlikely to be evidence that the issuer's or obligor's ability to pay its obligations when due has been compromised, while the latter could indeed be indicative of financial distress

Breaking Down New Event (16)-Financial Difficulties (cont.)

- However, this qualifier (reflecting financial difficulties), like materiality, has not been clearly defined, nor has the SEC provided guidance on how this standard should be interpreted
- Note also that this requirement will apply to a listed event relating to any of the issuer's or obligor's financial obligations, not solely those entered into after the Compliance Date
- Again, this brings into question an obligor's readiness to comply with the amendments

Preparing to Report New Listed Events/Best Practices

- Prior to first public bond sale after the Compliance Date, read and understand the *Adopting Release and other industry guidance;* attend industry meetings and webinars, read publications, and ideally obtain training from qualified legal counsel
- Adopting Release includes many helpful examples for when and how to report new events, including:
  - Prepare in Advance – Becoming prepared to comply at the time a new bond issue will be sold after February 27, 2019, will require much more time and work than was needed before to comply with a CDA
  - Form of Notice – Market participants are best suited to develop best practices; May submit summary of material terms of financial obligation or transaction documents (with appropriate redactions), or both

Preparing to Report New Listed Events/Best Practices (cont.)

Other important issues discussed in the Adopting Release include the following:

- GASB 87 – discontinuation of "capital lease" and "operating lease" labels in government accounting; Resulted in Adopting Release focus on lease arrangements that operate as vehicles for borrowed money
- GASB 88 – requires essential information related to debt to be disclosed in notes to financial statements, including unused lines of credit, assets pledged as collateral and key terms in debt agreements such as events of default, termination provisions and acceleration clauses. This can be useful in developing inventory of financial obligations and as a starting point for analysis of event reporting
- *However,* GASB 88 does not apply to all issuers and "debt" under the Rule is not exactly the same as GASB 88

Preparing to Report New Listed Events/Best Practices (cont.)

Other steps to take:

- Policies and Procedures – Review/amend compliance procedures to insure sufficient internal controls are in place to identify and report new events; Consider assigning key personnel responsible for:
  - Understanding the amendments, related guidance and new reporting requirements
  - Identifying and assessing new financial obligations for reporting
  - Monitoring events to determine if a default or other adverse event has occurred reflecting financial difficulties, or if there is a material amendment to terms of an existing financial obligation, either of which may require disclosure
  - Unlike existing 14 events which an issuer's financial staff will know about, for larger organizations the financial staff will not be directly aware if any of the three new types of events occur; Coordination between financial staff (who are usually responsible for Rule 15c2-12 compliance) and operating units of the organization is critical, including need for training
  - Consulting with bond counsel, disclosure counsel, financial advisor or other consultants

Preparing to Report New Listed Events/Best Practices (cont.)

- Inventory – Review internal records, including financial statements, to develop inventory of existing financial obligations and relevant material covenants and other terms, as necessary
  - Will help with timely identification of events reflecting financial difficulties, if and when they occur
  - Maintain and update inventory in spreadsheet or database as new reportable obligations are incurred
  - As noted above, coordination between financial and operational units of the organization will be critical

New Listed Events – Underwriter Considerations

- Issuer awareness of underwriter considerations – Understand approach of underwriters to verifying that issuers have complied with the new rules once deals are offered after February 27, 2019:
  - For first deal, underwriters may want to see new policies and procedures, or interview officials, to confirm appropriate internal controls are in place
  - For subsequent deals, they will need to determine if any of the (15) or (16) events have occurred and been reported within 10 business days
  - Underwriters will ask for certifications from the issuer, they will conduct some independent diligence such as examination of last audit, especially after GASB 88 goes into effect
  - There may be disagreement about whether an event was material or reflected financial difficulties. It will be helpful if the issuer can explain why it made a decision not to report, based on a memorandum to the file at the time the possible event occurred
  - The 10 day period to report may prove problematic, especially for large organizations; Better practice will be to make the EMMA filing even if later than 10 business days, and then report this in future official statements

How to Prepare

- Obligors and issuers should consider developing processes and procedures for becoming aware of these additional events in a timely manner, evaluating whether they are material or reflect financial difficulties, and preparing and filing the required notices, generally within 10 business days of the occurrence of the event.
- It seems likely that the most important and difficult element of this new, wider inquiry will be making a determination of what an issuer or obligor considers to be “material.”
- May be prudent to start inventory approach by referencing audit and financial obligations and agreements included in the audit.

A Word on Voluntary Postings

- Voluntary postings are not bad and can be useful/appreciated by investors
- Be consistent with voluntary postings
- Continue to use EMMA
- Consider covering voluntary postings in procedures

Hypotheticals

- Municipality issues bonds on March 30, 2019, and signs a CDA at closing; October 1, 2019: Municipality enters into a direct purchase with bank and amends its existing letter of credit agreement to make conforming changes; What notices are required?
- Municipality issues bonds on March 30, 2019 and signs a CDA at closing; The following week Municipality enters into an interest rate swap; What notices are required?