

Client Alert

March 2017

SEC Proposes Two New Event Notices for Municipal Bond Continuing Disclosure

On March 1, 2017, the SEC proposed adding two new event notices to Rule 15c2-12, which applies to municipal bonds. The proposed event notices are aimed at prompting timely, continuing disclosures by issuers and other obligated persons of direct purchases, direct loans or bank placements and other private placements. Along with the new event notices, the SEC is proposing a new definition of “financial obligation” intended to capture debt obligations of issuers that are not municipal securities for which a final official statement has been provided to EMMA. The SEC describes its proposed changes in SEC Release No. 34-80130 (the Proposing Release).

Specifically, the proposed amendments would require issuers or other obligated persons to provide event notices to EMMA reporting:

- Incurrence of a financial obligation of the issuer or 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
- 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.

These events are referred to as the Proposed Events. The proposed definition of “financial obligation” broadly “means a (i) debt obligation, (ii) lease, (iii) guarantee, (iv) derivative instrument, or (v) monetary obligation resulting from a judicial, administrative, or arbitration proceeding” but does not include municipal securities for which a final official statement has been provided on EMMA.

Generally, under the SEC proposal, issuers or other obligated persons would be required to post an EMMA notice of the two events described above within 10 business days of the actual incurrence of such financial obligation or occurrence of default.

Background

In its 2012 Report on the Municipal Securities Market, the SEC expressed concern that issuers and obligated persons may not properly disclose the existence or the terms of bank loans, particularly when the terms of the bank loans may affect the payment priority from revenues in a way that adversely affects bondholders. In the 2012 Report, the SEC indicated that it could amend Rule 15c2-12 to mandate continuing disclosures of new indebtedness not otherwise reported under Rule 15c-12. In the Proposing Release, the SEC again notes that, since 2009, issuers and obligated persons have increasingly used direct purchases of municipal securities and direct loans as alternatives to publicly offered municipal securities. The SEC cites its concern that existing bondholders and potential investors and other market participants (analysts, rating agencies) may not have any access or timely access to disclosure about direct placements or other financial obligations. The SEC’s key rationale is transparency: investors and market participants may lack access or experience delay in access to continuing disclosure about material financial obligations like direct loans or bank placements.

Below, we provide a more detailed description of the newly proposed event notices and examine the definition of “financial obligation.”

New Event Notice — Incurrence of Financial Obligation or Agreements — “If Material”

The SEC proposes that a materiality determination would apply in deciding whether incurrence of a financial obligation requires an event notice. Similarly, a materiality determination would apply to each of the agreed upon terms — agreement to covenants, events of default, remedies, priority rights or other similar terms — in evaluating whether the agreement requires an event notice. The SEC offers some examples in the Proposing Release, but is customarily reluctant to define “materiality.” Consequently, if this new event notice is added to Rule 15c2-12, issuers and obligated persons will need to consult with counsel and advisers regarding new financial obligations and whether such obligations are important to current bondholders and potential investors. Similarly, issuers will need to evaluate the materiality of covenants, events of default, remedies, priority rights or other similar terms that they may typically agree to in a bank loan or direct placement to decide if such agreements should be disclosed on EMMA. The SEC offers some examples in the Proposing Release: agreeing to covenants that are more restrictive than outstanding bond covenants; agreeing to events of default in a bank loan that differ from those in an issuer’s municipal securities; agreeing to acceleration provisions that may create a priority over existing bondholders; entering into a direct placement with a balloon payment at maturity creating refinancing risk that could affect an issuer’s creditworthiness.

In the Proposing Release, the SEC further advises that the event notice of the incurrence of a financial obligation or an agreement to the listed events above should include a description of the material terms of the financial obligation or agreement.

Definition of “Financial Obligation”

The SEC’s definition of “financial obligation,” while excluding municipal securities for which final official statements are posted on EMMA under Rule 15c2-12, is broad in its coverage: not just bank loans and direct placements, but lease arrangements (both financing and operating leases), guarantees, swap transactions and monetary obligations resulting from judicial, administrative or arbitration proceedings:

- *Debt Obligation* is intended to capture short-term and long-term debt obligations, such as a direct purchase or a direct loan by a bank;
- *Lease* would capture a capital lease, such as a lease-purchase agreement to acquire an office building, and an operating lease, such as leasing an office building for a specific term;
- *Guarantee* is intended to capture contingent financial obligations of the issuer or obligated person, as well as an issuer or obligated person that provides a self-liquidity feature to purchase back variable rate demand obligations that cannot be remarketed;
- *Derivative Instrument* captures any swap, security-based swap, futures contract, forward contract, option or any combination of these instruments;
- *Monetary Obligations resulting from Judicial, Administrative or Arbitration Proceeding* may be otherwise publicized, for example disseminated in the local media, but the material incurrence of such an obligation should be readily and promptly accessible to investors and market participants.

New Event Notice for Events “Reflecting Financial Difficulties” Under “Financial Obligation”

Current Rule 15c2-12 already contains two event notices “reflecting financial difficulties”: unscheduled draws on debt service reserve funds and unscheduled draws on credit enhancements. However, the SEC

points out that investors and market participants may lack any access or timely access to information regarding defaults, acceleration, termination, modification of terms or other similar events under the terms of a financial obligation and any of which reflect financial difficulties:

- *Default* could include a monetary or non-payment default;
- *Event of Acceleration* in tandem with a default if reflecting financial difficulties could impact an issuer's liquidity and creditworthiness;
- *Termination Event* could include a termination fee payable by the issuer or obligated person under a swap agreement;
- *Modification of terms* often occurs in distressed financial situations, including negotiation of covenant changes that may provide priority rights with respect to existing bondholders;
- *Other similar events* may include failing to meet a construction deadline that reflects financial difficulties.

The SEC proposes that such event notices should include a description of the event and the consequences of the event, if any.

Conclusion

The first Proposed Event will require added materiality decisions by issuers and obligated persons. The second Proposed Event will require determinations of what occurrences under financial obligations may reflect financial difficulties. The scope of these Proposed Events and proposed definition remain unclear.

New Event Notices and Definition Are Proposed Only; Potential Effective Date

The two new event notices and proposed new definition of "financial obligation" are open for public comment for a period of 60 days after publication in the Federal Register. The SEC proposes that if the Commission approves the proposed amendments, the amendments could become effective three months after final adoption. In anticipation that the proposed amendments will be finally adopted in substantially the form proposed, and assuming a 90-day period to effectiveness, issuers and obligated persons can expect heightened due diligences by underwriters, municipal advisers, analysts and rating agencies regarding current disclosure of bank loans, direct placements and other financial obligations described above.

Hunton & Williams LLP is prepared to assist clients who may seek to submit comments to the SEC regarding these proposed amendments to Rule 15c2-12. We are also ready to respond to any questions you may have regarding compliance with continuing disclosure requirements and municipal securities generally.

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