HAWKINS

RULE 15c2-12 Amendments —Implementation

Hawkins Advisory

03.21.2019

Introduction

The compliance date for the recent amendments to Securities and Exchange Commission ("SEC") Rule 15c2-12[1] was February 27, 2019. Hawkins published Advisories on August 22, 2018, and October 10, 2018, which described these amendments and the guidance provided in the Adopting Release.[2] We also made suggestions for complying with these amendments. We noted that there may be additional guidance from the SEC staff[3] as various issues are considered in implementing the amendments. This Advisory describes the SEC staff guidance that has been provided to date on several significant matters arising under the amendments.

The Amendments

The amendments add two paragraphs that must be included in any continuing disclosure agreement ("CDA")[4] that is executed on or after February 27, 2019. The additional paragraphs are the following:

Rule 15c2-12(b)(5)(i)(C)(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.

Rule 15c2-12(b)(5)(i)(C)(16):

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.

Significantly, the introductory language of Rule 15c2-12(b) (5)(i)(C) provides that notice of the listed events must be provided "[i]n a timely manner not in excess of ten business days after the occurrence of the event . . . ***with respect to the securities being offered in the Offering***." Accordingly, notice of the incurrence of a financial obligation or execution of an agreement described in paragraph (15) or an event specified in paragraph (16) is required to be filed with the Municipal Securities Rulemaking Board (the "MSRB") only if it is material, directly or indirectly, to the holders of the securities that are the subject of the applicable CDA.

The term "financial obligation" is key to paragraphs (15) and (16) and is defined in new paragraph (f)(11) of Rule 15c2-12 as follows:

(11)(i) The term *financial obligation* means a:

(A) Debt obligation;

(B) Derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or

(C) Guarantee of (f)(11)(i)(A) or (B).

(ii) The term *financial obligation* shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

Key Implementation Points

- Event (15) has two distinct elements. One, the "[i]ncurrence of a financial obligation" And two, an "agreement to covenants [etc.] . . . of a financial obligation." The second element of event (15), as is the case with respect to event (16), applies to all financial obligations of the obligated person, including those in effect prior to the compliance date of February 27, 2019.
- The Adopting Release states that "the definition of the term 'financial obligation' does not include ordinary financial and operating liabilities incurred in the normal course of an issuer's or obligated person's business, only an issuer's or obligated person's debt, debt-like, and debt -related obligation."
- The SEC staff has advised that draw-down bonds and commercial paper are "incurred" when the related program is established and the legal documents are executed, which may be before the first draw occurs. Consequently, a notice is required only when the legal documents are executed and not when each draw is made or each issuance (or roll) of commercial paper occurs.
- The Adopting Release provides the following advice regarding a material event notice of an event described in paragraph (15):

[The notice] generally should include a description of the material terms of the financial obligation. Examples of some material terms may be the date of incurrence, principal amount, maturity and amortization, interest rate, if fixed, or method of computation, if variable (and any default rates); other terms may be appropriate as well, depending on the circumstances. . . .
. . . .

[But any such notice would not] require the provision of confidential information such as contact information, account numbers, or other personally identifiable information.

The notice may include a redacted document or a summary of its terms consistent with the foregoing.

- A debt issue that meets the private placement exemption in Rule 15c2-12(d)(1)(i) is a "debt obligation" and as such a "financial obligation" for which a notice is required under paragraph (15). If an issuer wants to exclude such debt issue from the definition of "financial obligation," it must file the related final Official Statement with the MSRB and enter into a CDA for such municipal securities, notwithstanding that such debt issue is exempt from the Rule. This conclusion is based on advice from the SEC staff regarding how to interpret the phrase "consistent with this rule" in Rule 15c2-12(f) (11)(ii).
- Certain "guarantees" or "derivative instruments" are "financial obligati" The definition of "financial obligation" by its terms only excludes "municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule." Nevertheless, the SEC staff has advised that if the principal terms of the "guarantee" or the "derivative instrument" are set forth in a final Official Statement that

is filed with the MSRB, such filing will result in the associated guarantee or derivative being excluded from the definition of "financial obligation."

- Regarding such analysis, it is important to distinguish the respective contractual obligations[5] of the guarantor and of the beneficiary of the guarantee. For example, in the case of a guarantee by a governmental entity (e.g., a State) of a governmental issuer's (e.g., a County) municipal securities, the State as the guarantor and an obligated person would be subject to its own notice requirement. The County can exclude from the definition of "financial obligation" an associated State guarantee by filing the related final Official Statement that describes the terms of the municipal security and the guarantee, and associating the Official Statement with the County's affected CUSIPs. The State as guarantor is required, under any post-February 27, 2019 CDA to which it is a party, to make an event (15) filing for the guarantee. The filing could be accomplished by filing the County's Official Statement and associating such filing with the State's CUSIPs of bonds that are secured, directly or indirectly, by the same source of funds that backs the State's guarantee.
- The SEC staff has advised that the phrase "reflect financial difficulties" as used in event (16) should be read to mean "caused by financial difficulties" Note that event (16), similar to certain other events, is not modified by the phrase "if material."[6]
- With respect to a "debt obligation" as an element of "financial obligation," the Adopting Release states that whether an obligation was "debt" for state law purposes is not determinative:

[I]n the context of Rule 15c2-12, the Commission is not limiting the term "debt obligation" to debt as it may be defined for state law purposes, but instead is applying it more broadly to circumstances under which an issuer or obligated person has borrowed money. . . . The Commission believes that, for the purposes of Rule 15c2-12, a narrow interpretation of "debt" would be under-inclusive because issuers and obligated persons can, and often do, borrow money through a variety of transactions, many of which would not qualify as "debt" under relevant state laws.

- Certain of the numerous interpretive issues regarding leases as financial obligations are addressed under a separate heading below.

Leases: Are They Financial Obligations?

In the release that proposed the amendments (the "Proposing Release"),[7] the SEC defined the term "financial obligation" to include a "lease" as a separate specified type of financial obligation. In the Adopting Release, however, the SEC recognized that the term "lease" was too broad:

The Commission agrees with commenters that, as proposed, the term "lease" was too broad. Accordingly, the Commission believes that it is appropriate to limit the Rule's coverage of leases to those that **operate as vehicles to borrow money**. The Commission believes that this is appropriate because a lease entered into as a vehicle to borrow money **could represent competing debt** of the issuer or obligated person. (emphasis added)

Accordingly, a lease entered into as a vehicle to borrow money should be treated as a variety of "debt obligation" rather than a separate type of "financial obligation," as had been proposed.

The SEC also stated in the Adopting Release that in light of GASB Statement 87, Leases, which eliminated the distinction between operating and capital leases for governmental accounting purposes, a distinction between operating and capital leases was also not useful in determining what leases may be "financial obligations."

In the Adopting Release, the SEC provided examples of the types of leases that could be considered debt obligations, and therefore would be financial obligations:

For example, the types of leases that could be debt obligations include, but are not limited to, lease-revenue transactions and certificates of participation transactions. Typically, in a lease-revenue transaction, an issuer or obligated person borrows money to finance an equipment or real property acquisition or improvement and a lease secures the issuer's or obligated person's obligation to make principal and interest payments to the lender . . . . In a certificates of participation transaction, the issuer or obligated person sells certificates of participation and the proceeds of the certificates are used, typically, to finance an equipment or real property acquisition or improvement by the issuer or obligated person.

In the Adopting Release, the SEC also provided examples of leases that would **not** be financial obligations because they do not operate as vehicles to borrow money. The Adopting Release states:

With respect to leases that do not operate as vehicles to borrow money, the Commission agrees with commenters that the burden of assessing their materiality and disclosing such leases within ten business days would not justify the benefit of such disclosures. While the Commission continues to believe that lease arrangements that are not vehicles to borrow money might be relevant to the general financial condition of an issuer or obligated person, the Commission also believes that such lease arrangements do not warrant inclusion in the Commission's definition of "financial obligation" because they generally do not represent competing debt of the issuer or obligated person. . . .

. . . .

Examples of such leases that are typically not vehicles to borrow money that are common among issuers and obligated persons include, but are not limited to: commercial office building leases, airline and concessionaire leases at airport facilities, and copy machine leases.

The SEC staff advised that a critical factor in its analysis of whether a lease was a financial obligation was the presence or absence of a third-party lender.

Underwriter and Issuer Responsibilities

A broker-dealer acting as an underwriter in a primary offering of municipal securities is required, pursuant to Rule 15c2-12(b)(5), to reasonably determine that a governmental issuer and any obligated person will comply with their respective continuing disclosure obligations as set forth in the CDA executed in connection with such securities offering. To establish such reasonable determination, underwriters will be considering, among other issues, whether the issuer and any obligated person (i) have trained the appropriate personnel regarding the two new events, (ii) will be in a position to make the determinations whether an event is a "financial obligation," and if it is, whether such event was "material" [paragraph (15)] or "reflect[ed] financial difficulties" [paragraph (16)], and (iii) could provide notice to the MSRB in a timely manner, not in excess of ten business days after the occurrence of the event.

It is important to note that in connection with an issuer's initial CDA executed after the compliance date of February 27, 2019, an underwriter's diligence review will include careful consideration of the points noted in the preceding paragraph. For subsequent financings, the underwriter's diligence review will also include a review of the issuer's and any obligated person's history of compliance with those CDAs that include new events (15) and (16).

1 17 CFR §240.15c2-12.

2 SEC Rel. No. 34-83885 (Aug. 20, 2018).

3 This Advisory distinguishes between guidance provided by the Commission and guidance provided by SEC staff. The Commission was established by Section 4 of the Securities Exchange Act of 1934. The Adopting Release is a statement of the Commission. The SEC staff advice is informal, and is not binding on the Commission.

4 "Continuing disclosure agreement" or "CDA" as used in this Advisory mean the "written agreement or contract" required by and described in detail in Rule 15c2-12(b) (5)(i).

5 Event (15) relates to "[i]ncurrence of a financial obligation of the obligated person." "Guarantee" is an element of the term "financial obligation." In the case of a moral obligation of the guarantor or a guarantee subject to legislative appropriation, it is unclear whether the guarantor would be an "obligated person," which is defined in Rule 15c2-12(f)(10) as a "person committed by contract or other arrangement."

6 Prior to the 2010 amendments to Rule 15c2-12, the ten events requiring notice were preceded by the phrase "if material." In 2010, four events were added to the Rule, the phrase "if material" was deleted from the lead-in clause, and "if material" was inserted after some events and not others. This is best read as the Commis-sion concluding that some events were, in effect, deemed to be material in all instances, and therefore notice would always be required.

7 SEC Rel. No. 34-80130 (Mar. 1, 2017).

About Hawkins Advisory

The Hawkins Advisory is intended to provide occasional general comments on new developments in Federal and State law and regulations that we believe might be of interest to our clients. Articles in the Hawkins Advisory should not be considered opinions of Hawkins Delafield & Wood LLP. The Hawkins Advisory is not intended to provide legal advice as a substitute for seeking professional counsel; readers should not under any circumstance act upon the information in this publication without seeking specific professional counsel. Hawkins Delafield & Wood LLP will be pleased to provide additional details regarding any article upon request.

Practices

- Securitization
- Bond Counsel
- Disclosure Counsel