HAWKINS ADVISORY

RULE 15c2-12 AMENDMENTS – COMPLIANCE ALERT

Introduction

This Compliance Alert supplements the Hawkins Advisory entitled "Rule 15c2-12 Amendments," which was dated August 22, 2018. That Advisory is appended to this Alert. The Advisory describes two new paragraphs (15 and 16) that are required to be added to continuing disclosure agreements that are entered into pursuant to Rule 15c2-12 ("CDAs") on and after February 27, 2019 (the "compliance date," which is 180 days after the publication of the Adopting Release in the Federal Register[1]). Thus, CDAs that are entered into on or after February 27, 2019, must incorporate new paragraphs (15) and (16). This Alert brings to your attention some considerations to keep in mind as the compliance date approaches.

"Financial Obligation"

The term "financial obligation" is key to paragraphs (15) and (16), and is defined in new paragraph (f)(11), as follows:

> The term financial obligation means 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) guarantee of (i) or (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.

The exclusion for "municipal securities as to which a final official statement" was provided to the MSRB only excludes the municipal securities themselves, and does not exclude any associated financial obligation, such as a derivative instrument or a guarantee of either a derivative instrument or a debt obligation. That is the case even if such associated financial obligation was entered into in connection with or pledged as security for the municipal securities and was described in the related official statement.

The phrase "provided to the Municipal Securities Rulemaking Board consistent with this rule," would include official statements that are provided to the MSRB ***voluntarily***. Thus, for municipal securities for which the related official statement was provided to the MSRB, either because required by Rule 15c2-12 or voluntarily, a notice would not be required under paragraph (15) relating to the issuance of such securities.

The SEC noted 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 obligations." This limitation must be viewed in light of the SEC's statement that whether an obligation is "debt" for state law purposes is not determinative for the purposes of Rule 15c2-12, and that "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."

Pursuant to paragraph (15), the "incurrence" of a financial obligation triggers the disclosure obligation. With respect to financial obligations arising under contracts that are ***not*** municipal securities subject to a CDA, the Adopting Release states that the financial obligation "generally should be considered to be incurred when it is enforceable against an issuer or obligated person." The Adopting Release notes that this is consistent with the instructions for Item 2.03 of Exchange Act Form 8-K, which provide that a registrant:

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[1] 83 Fed. Reg. 44,700 (Aug. 31, 2018).

> has no obligation to disclose information . . . until the registrant enters into an agreement enforceable against the registrant, whether or not subject to conditions, under which the direct financial obligation will arise or be created or issued.

For many transactions (other than municipal securities subject to a CDA), where a contractual commitment or sale agreement has been entered into prior to closing or funding (e.g., certain bank loans), it may be prudent to treat the incurrence of financial obligations as occurring upon the sale or commitment date rather than the closing date.

Preparation for Compliance Date

Paragraph (15) relates to the incurrence of financial obligations or entering into certain agreements that occur on or after the compliance date of February 27, 2019. Paragraph (16), however, includes defaults or other events with respect to financial obligations entered into on, after, or prior to February 27, 2019, including currently existing financial obligations. Thus, an issuer or obligated person that expects to become a party to a CDA entered into after the compliance date should begin well in advance of such compliance date to identify the contracts under which it may have financial obligations and the payment, pledge, priority, financial covenant, default, and remedy provisions that are most likely to trigger a filing under paragraph (16).

Many governmental issuers, and certain other obligated persons, may find that their audited financial statements and audit process may provide a useful starting point for identifying existing financial obligations. As an example, a governmental issuer whose financial statements comply with Governmental Accounting Standards Board ("GASB") standards is required, for reporting periods beginning after June 15, 2018, to comply with GASB 88, entitled "Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements."[2] GASB 88 defines "debt," for purposes of disclosures in notes to financial statements, "as a liability that arises from a contractual obligation to pay cash . . . in one or more payments to settle an amount that is fixed at the date the contractual obligation is established . . . debt does not include leases, except for contracts reported as a financed purchase of the underlying asset."

However, even governmental issuers and obligated persons whose financial statements comply with GASB requirements should be aware that both the scope of their particular financial obligations that satisfy the Rule 15c2-12 "financial obligation" definition and the content of required disclosures thereunder may well vary from GASB requirements. In addition, timing of disclosure also will be different under applicable CDAs. One of the express purposes of the amendments to Rule 15c2-12 is to require disclosure of a paragraph (15) or (16) event prior to the time that financial statements are published. As stated in the Adopting Release, "GASB Statement No. 88 is not a substitute for [the] amendments."

All of these obligations will need to be reconciled with any confidentiality or non-disclosure provisions that may apply, and these should be carefully reviewed with your advisors. With respect to financial obligations or agreements of the type described in paragraph (15) that are incurred or agreed to after the compliance date of February 27, 2019, an issuer or obligated person should consider an express acknowledgement by the contracting party that disclosure may be required under any CDA that includes paragraph (15).

There may be additional guidance from the SEC staff as various issues are considered in implementing paragraphs (15) and (16). For example, the SEC retained the introductory language of Rule 15c2-12(b)(5)(i)(C), which 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) ought to be required to be filed with the MSRB only if it is material, directly or indirectly, to the holders of the securities that are the subject of the applicable CDA.

In addition to establishing a comprehensive list of financial obligations, an issuer should revise any written continuing disclosure controls and procedures, and update any associated training presentations or materials, to reflect paragraphs (15) and (16).

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[2] GASB 88 amends GASB 34, paragraph 119. Paragraph 119 currently requires "[i]nformation about long-term liabilities [which] should include both long-term debt (such as bonds, notes, loans, and leases payable) and other long-term liabilities."

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Introduction

On August 20, 2018, the Securities and Exchange Commission ("SEC" or "Commission") adopted amendments to Securities Exchange Act of 1934 Rule 15c2-12 (17 CFR § 240.15c2-12)[1] ("Rule 15c2-12" or the "Rule"). The amendments add two events that must be included in any continuing disclosure agreement[2] that is entered into after the compliance date (approximately six months from now; see "Compliance Date" below). The two additional events 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.

The disclosures that would be required by the amendments are already being made. The amendments address *when* such disclosures must be made. In general, material financial information of the type described in new paragraphs (15) and (16) is included in official statements and/or audited financial statements. The SEC, however, wanted to have such disclosures made closer to the time of the incurrence or event, to provide greater transparency to the market. The Adopting Release notes:

> [I]nvestors and other market participants may not learn that the issuer or obligated person has incurred a financial obligation if the issuer or obligated person does not provide annual financial information or audited financial statements to EMMA or does not subsequently issue debt in a primary offering subject to Rule 15c2-12 that results in the provision of a final official statement to EMMA.

The impetus for the amendments was the increasing use of direct purchases of municipal securities and direct loans as alternatives to public offerings of municipal securities. Although market participants had encouraged over the years voluntary disclosure of such financial obligations, the SEC concluded that "despite these ongoing efforts, few issuers or obligated persons have made voluntary disclosures of financial obligations, including direct placements, to the MSRB [Municipal Securities Rulemaking Board]."

Analysis of Provisions

The two new provisions reference "financial obligation of the obligated person."[3] Note that, pursuant to existing paragraph (b)(5)(i), the party to the continuing disclosure agreement may be either the issuer or the obligated person (even if the issuer is not an obligated person).

The term "financial obligation" would be added by the amendments as new paragraph (f)(11), as follows:

> The term financial obligation means 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) guarantee of (i) or (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.

The amendments in proposed form had included "lease" as a distinct financial obligation. The SEC did not include "lease" in the definition as adopted on the rationale that item (11)(i), "debt obligation," would include those leases the SEC considered to be financial obligations:

[1] SEC Rel. No. 34-83885 (Aug. 20, 2018) (the "Adopting Release").

[2] "Continuing disclosure agreement" references the "written agreement or contract" required by and set forth in detail in Rule 15c2-12(b)(5)(i).

[3] "Obligated person" is defined in Rule 15c2-12(f)(10) as follows:

> The term *obligated person* means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

> 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.
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> With respect to leases that do not operate as vehicles to borrow money . . . 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.

In addition, the amendments in proposed form had included as a "financial obligation" a "monetary obligation resulting from a judicial, administrative, or arbitration proceeding." The SEC determined to not include such monetary obligation on the reasoning that any such obligation is typically covered by reserve funding or insurance, and further that any initial judgment in such a proceeding may not reflect the ultimate disposition of the proceeding.

With respect to item (11)(i), "debt obligation," the SEC noted that whether an obligation was "debt" for state law purposes was 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.

In connection with the phrase "reflect financial difficulties" in paragraph (16), the SEC reasoned that such phrase does not need further clarification because the same phrasing is used in paragraphs 15c2-12(b)(5)(i)(C)(3) and (4), as in effect since 1995.

For purposes of a material event notice of an event described in paragraph (b)(5)(i)(C)(15), the SEC advised that such notice:

> [G]enerally 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.

Compliance Date

The compliance date is 180 days after publication of the SEC Release in the Federal Register. The SEC notes that the amendments would apply to "continuing disclosure agreements that are entered into in connection with Offerings occurring on or after the compliance date of the amendments." The use of the term "Offerings" could create some ambiguity because, for purposes of Rule 15c2-12(b)(1), the SEC had tied such term to the use of a Preliminary Official Statement.[4] In the Adopting Release, the SEC provided the needed clarification: "For the purposes of these amendments, the Commission believes that an Offering generally should be considered to occur on the date the continuing disclosure agreement is executed." Such execution will generally occur on the settlement date. The SEC notes, however, that:

> [I]f a preliminary official statement is distributed before the compliance date, with an expectation that the Offering will occur on or after the compliance date, the preliminary official statement should generally attach a form of continuing disclosure agreement that reflects the adopted amendments.

The SEC also advised that "an event under the terms of a financial obligation pursuant to (b)(5)(i)(C)(16) that occurs on or after the compliance date must be disclosed regardless of whether such obligation was incurred before or after the compliance date." Thus, for example, assuming a compliance date of February 25, 2019, and a continuing disclosure agreement executed after such date that incorporates new paragraph (16), notice of an event as described in such paragraph (e.g., default or termination event) must be posted on EMMA, even if the associated financial obligation was entered into prior to February 25, 2019.

[4] SEC No-Action Letter (Mudge Rose letter) dated April 4, 1990: "The term 'offer' traditionally has been defined broadly under the federal securities laws and, for purposes of Rule 15c2-12, would encompass the distribution of a Preliminary Official Statement by the underwriter."

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