

Time To Prepare For New Municipal Securities Disclosures

By **Laura Kurtz** (September 10, 2018, 1:15 PM EDT)

The U.S. Securities and Exchange Commission recently adopted amendments to 17 CFR 240.15c2-12 under the Securities Exchange Act of 1934. The rule prohibits underwriters from purchasing or selling municipal securities unless they reasonably determine that an obligated person has agreed to provide, among other things, timely notice of the occurrence of certain events ("event notices").

Final amendments to the rule will require disclosure of two new event notices within 10 business days of their occurrence, including:

1. The incurrence of a financial obligation of the obligated person or an obligated person's agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation, 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.



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The term "financial obligation" is defined to include a debt obligation or derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation, or a guarantee thereof. The use of "debt obligation" by the SEC was intended to capture short- and long-term debt of an obligated person under the terms of an indenture, loan agreement or similar contract that will be repaid over time. The term is not limited to debt as it may be defined for state law purposes and does not include municipal securities for which a final official statement has been provided to the Municipal Securities Rulemaking Board (MSRB) Electronic Municipal Market Access (EMMA) system in accordance with the rule.

The SEC stated, in a release that accompanied the two amendments, that these amendments will facilitate market participant access to important information in a timely manner, improve transparency and investor protection, and are consistent with its mandate to prevent fraudulent, deceptive or manipulative practices in the municipal securities market.

The SEC also stated commenters on the then-proposed amendments generally supported enhanced transparency in the municipal market, but conveyed concerns over the costs associated with compliance. Commenters also asked for additional guidance on the materiality qualifier related to the first new event notice; however, many of the comments

centered on the vagueness of the term “financial obligation.”

The SEC offered little guidance on materiality. The SEC reiterated an equivocal conclusion from a 1994 interpretive release providing that information is material if there is a substantial likelihood that, under all circumstances, it would have assumed actual significance in the deliberations of the reasonable investor. In other words, there must be a substantial likelihood that the disclosure would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available in making an investment decision.

The SEC further provided that a materiality determination requires the same facts and circumstances analysis that is regularly made when preparing offering documents. While the SEC acknowledged that individuals may consider a number of factors when assessing materiality and may have differing opinions with respect to whether or not a piece of information would be considered important to a reasonable investor when making an investment decision, they declined to provide additional guidance.

Much more consideration was given to the definition of “financial obligation,” which does not include ordinary financial and operating liabilities incurred in the normal course of business, but only an obligated person’s debt, debt-like and debt-related obligations — the types of obligations that could impact liquidity, overall creditworthiness, or an existing security holder’s priority or other rights. The SEC asserts that the objective is to provide important information about the obligated person’s current financial condition.

The SEC further explained that the term does not take into account “true” leases, but does include arrangements entered into, whether or not characterized as “financing” or “capital” leases, that operate as vehicles to borrow money, which are in fact debt obligations. While the SEC believes that lease arrangements that are not vehicles to borrow money might be relevant to the general financial condition of an obligated person, it acknowledged that such leases should not be included because they generally do not represent competing debt of an obligated person (which may contain, for example, acceleration provisions or more restrictive debt service covenants).

Since 2016, the SEC had been encouraging voluntary disclosure of financial obligations, but the agency reported that such submissions have been limited. The amendments to the rule come as many issuers have been, in more recent years, issuing debt outside of the public market, particularly through bank loans, private placements or direct purchases of debt. Direct bank lending to state and local governments and their instrumentalities rose to over \$190 billion in the final quarter of 2017 and the first quarter of 2018. Still, this number does not compare to the over \$3.844 trillion municipal securities that are currently outstanding.

In an effort to justify the amendments, the SEC pointed out that six of the seven largest municipal bankruptcy filings in U.S. history have occurred since 2011, and some obligated persons continue to experience declining financial situations and steadily increasing debt burdens. The SEC stated that defaults due to such debt burdens may negatively impact investors in ways other than nonpayment, including delayed payments and pricing disruptions in the secondary market.

The SEC already requires the disclosure of notices of certain events reflecting financial difficulties of obligated persons, some of which are related to publicly offered securities, like defaults and delinquencies, certain unscheduled draws, and release of property securing repayment, and others that are related to the overall fiscal condition of the obligated person — most notably, bankruptcy, insolvency, receivership or similar events, and merger, consolidation or acquisition, or sale (outside of the ordinary course of business) of substantial assets of an obligated person, if material. Accordingly, if obligated persons are experiencing fiscal distress that is significant enough in nature to warrant

disclosure under the existing events, notices evidencing such fiscal condition would already be posted to EMMA. In addition, many obligated persons are currently required to provide financial statements, which reflect all debt. So, while investors may not immediately know the terms of bank loans or other debt obligations, they should have already known about their existence.

In order to prepare for compliance, some commenters stated that without more guidance, obligated persons would likely utilize outside counsel in order to make materiality determinations. To avoid the time and expense of reviewing all of their financial obligations for materiality, and to prevent being second-guessed by underwriters in the future, obligated persons may decide to disclose all of their financial obligations, inundating EMMA with potentially immaterial information.

In addition, in light of the potential liability associated with summarizing terms of a financial obligation, entire swap agreements or loan documents are likely to be posted on EMMA. To ease the time and cost burdens with respect to making such determinations, the SEC only offered that obligated persons can amend policies and procedures to address the process for evaluating disclosure of material financial obligations, in addition to waiting for industry practices that may develop.

The SEC estimate of the time burden on each underwriter in complying with the amendments is approximately 505 hours each year. In addition, the SEC believes that 28,000 issuers are affected by the disclosure requirements, and their total aggregate burden is 755,018 hours each year. Per the SEC, the amendments are slated to result in 2,200 more event notices filed annually, increasing costs for obligated persons using a dissemination agent, and further necessitating the retention of outside counsel to assist in the evaluation and preparation of new event notices, and to revise current continuing disclosure agreements to reflect the new events.

The compliance date of the amendments is Feb. 27, 2019.

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