WHITEPaper

A PUBLICATION OF COLUMBIA CAPITAL MANAGEMENT, LLC

APRIL 2019

CONTINUING DISCLOSURE CHANGES | NEW MATERIAL EVENT DISCLOSURES REQUIRED BY SEC RULE 15C2-12

TAKEAWAYS

- Continuing disclosure agreements entered into on and after February 27, 2019 will include two new material event disclosures: (1) incurrence of new material financial obligations and substantial modifications to existing financial obligations; and (2) payment and non-payment defaults or other indications of financial difficulty on such financial obligations.
- Issuers and borrowers will need to catalogue and summarize any financial obligations and determine whether they are material, given the relevant facts and circumstances.
- Issuers and borrowers will need to amend their post-issuance compliance procedures to incorporate the requirements imposed by this change.

BACKGROUND

Except with respect to its enforcement of anti-fraud regulations, the US Securities and Exchange Commission (SEC) has no authority to regulate municipal bond issuers and borrowers directly. Instead, it works through municipal securities dealers, which it *does* have authority to regulate, to implement changes in the municipal bond industry. By requiring dealers to take certain actions or avoid certain situations in their business of buying and selling municipal bonds, the SEC can indirectly guide the actions of municipal bond issuers and borrowers.

Most issuers will be familiar with SEC Rule 15c2-12 (the Rule), even if the statutory citation doesn't ring a bell. The Rule requires that municipal security dealers impose continuing disclosure responsibilities on issuers and borrowers for whom they underwrite bonds. Readers who have been involved in the muni world for any period of time will recognize the Rule when they post their annual audits to the MSRB's Electronic Municipal Market Access (EMMA) system, or file a notice of "material event" like a rating change. Until recently, the Rule included 14 material events:

Rule 15c2-12 Material Events (prior to February 27, 2019)

Principal and interest payment delinquencies	Bond calls and tender offers
Non-payment related defaults	Defeasances
Unscheduled draws on debt service reserves reflecting financial difficulties	Release, substitution or sale of property securing repayment of the securities
Unscheduled draws on credit enhancements reflecting financial difficulties	Rating changes
Substitution of credit or liquidity providers, or their failure to perform	Bankruptcy, insolvency or receivership
Adverse tax opinions or events affecting the tax-exempt status of the security	Merger, acquisition or sale of all issuer assets
Modifications to rights of security holders	Appointment of successor trustee

Commencing with bonds closing on and after February 27, 2019, however, the Rule now imposes two additional material events:

15. 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 issuer or 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 the terms of the financial obligation of the issuer or obligated person, any of which reflect financial difficulties.

Issuers and borrowers are required to provide notice to EMMA on the new events within ten (calendar or business?) days of their incurrence, consistent with existing practice. For the purposes of this section, "incurrence" means the date on which the financial obligation becomes enforceable against the issuer/borrower or on which the default, acceleration, termination, modification or similar event occurs.

ANALYSIS

What are "financial obligations"? Generally, they are debt or debt-like instruments for which the issuer or borrower has not posted a final official statement to the EMMA system. More specifically, financial obligations include: debt obligations (other than municipal securities for which an official statement has been filed on EMMA); derivative instruments entered into in connection with, or pledged as security or source of payment for, an existing or planned debt obligation; or, a guaranty of such debt obligations or derivatives. Examples of financial obligations include loan agreements, bank direct purchases, lease-purchase agreements, letters of credit and lines of credit.

"Derivative instruments" include swaps, futures contracts, forward contracts, options or similar instruments related to an existing or planned debt obligation. For the purposes of the Rule, derivatives do not include fuel hedges, energy hedges or other similar instruments not related to existing or planned debt obligations.

Leases that are not vehicles to borrow money (real estate leases, office equipment leases, etc.) are not financial obligations. I know GASB and FASB do not want us to think about operating leases vs. capital leases any more, but, generally, leases that you previously would have classified as an operating lease will not be subject to the Rule.

You are obligated to disclose a financial obligation only if it is material. What is "material"? You will need to assess the obligation in light your operations and debt structure. An event is "material" under federal securities laws if a reasonable investor would consider it important in making an investment decision. Materiality is affected by a variety of factors, including the size of a financial obligation compared to your overall balance sheet and debt outstanding, the security for repayment pledged to the financial obligation (versus that pledged to bondholders), the financial obligation's seniority position versus your bonds, the financial obligation's covenants, and any remedies available to the lender in the event of a default.

As an example, if you have a $100 million general fund budget, a lease that qualifies as a financial obligation that imposes a $100,000 per year annual payment obligation is probably not material. But, if a default under that lease were to cross-default with your other bonds or financial obligations, you may determine that $100,000 per year lease to be material after all. Based upon SEC commentary, we believe issuers and borrowers should consider any financial obligation that gives its lender/holder preferential or priority rights over the issuer's/borrower's publicly held bonds to be material.

What is a "default"? SEC commentary indicates that a default, in this instance, could be an event reflecting financial difficulties that does not rise to an event of default under the financial obligation's documents. We believe issuers and borrowers should construe "default" broadly.

We note that many bank direct placement documents require the issuer/borrower to keep the terms confidential. This confidentiality requirement may create conflicts with the Rule. The easiest approach for issuers/borrowers is likely to post the operative document related to a financial obligation that contains its key terms. Instead, however, issuers/borrowers can post a summary to include (but not necessarily be limited to):

- date incurred
- principal amount

- maturity dates and amortization
- interest rate, if fixed, or method of computation, if variable, and default rates, and
- such other terms as are appropriate under the circumstances, likely including covenants, events of default and lender/provider recourse in the event of a default (acceleration, foreclosure on real estate, etc.)

It is not clear that the rule would permit exclusion of this information if the lender/provider required confidentiality, but an issuer or borrower may exclude or redact confidential information such as contact information, account numbers and other personally-identifiable information from EMMA filings of financial obligations.

Whose idea was this? The SEC referenced in its commentary the growth in bank direct purchase structures over the last decade as a precipitating factor. Until February 27, issuers and borrowers could, but were not required to, disclose the evidence of financial obligations on EMMA. As a result, the SEC indicated the potential for inadequate disclosure in this area.

In my humble opinion, there are two groups who fanned the flames of this idea: analysts for institutional investors and rating agencies. The rating agencies, in particularly, have been vocal in their concern (some legitimate, some certainly self-motivated) about the growth in so-called bank direct purchases over the last decade. Bank direct purchases (or DPs) are financings where the issuer or borrower places bonds directly with a bank. Generally, the bank treats this as a loan on its books—it is not distributed to other investors like a traditional capital markets transaction and typically has very limited transfer provisions (e.g. to other qualified institutional buyers). Bank DPs generally do not require an official statement, do not carry bond ratings, do not subject the issuer/borrower to EMMA secondary market disclosure and often do not have CUSIPs (the unique serial number assigned to each maturity of a traditional bond financing).

The rise of bank DPs to popularity began in the wake of the credit crisis, primarily with banks that had been active players in the letter of credit (LC) market for variable rate demand bonds (VRDBs). VRDBs are bonds issued with a variable rate of interest, often reset daily or weekly, for which investors have the right to "put" the bonds back to the issuer on each interest rate reset date. Because the issuer probably could not come up with, say, $100 million on any given day to satisfy the put, the issuer instead would contract with a bank to provide that liquidity if necessary. Structured correctly, bank letters of credit providing liquidity for VRDB put events also resulted in a substitution of credit for the issuer, meaning that investors were taking the *bank's* credit risk rather than the *issuer's*. This structure was (and remains) common for entities that likely would not receive investment grade credit ratings on their own. For this reason, private colleges and universities, cultural institutions, non-profit

organization and distressed local governments frequently used bank-supported VRDBs to access the credit markets.

The LC market more or less seized during the credit crisis late in the last decade as many banks failed and even more teetered on the brink. Most banks (other than the ones bright enough to avoid US subprime market exposure) suffered ratings downgrades and, by 2010, were no longer trusted by investors as a credit enhancer/liquidity provider. The banks that remained would generally extend credit only to issuers/borrowers who didn't need it and, even then, at a premium.

The effective collapse of the LC market left banks without a valuable line of business and left issuers and borrowers without investment grade credit ratings in a very tough spot. Banks quickly began to offer bank DPs as an alternative to LC-backed variable rate bonds. Once DPs became institutionalized among issuers/borrowers that were common players in the LC market, banks began to broaden their net by offering DP structures to issuers with significant market access on their own. They offered the promise of quick execution and lighter administrative effort by issuers and borrowers. As anyone who suffered an unexpected interest rate increase on their bank DP at the beginning of 2018 will tell you, there are definitely trade-offs versus publicly-offered bonds. But, that's a topic for another White Paper.

Further, in recent years many banks have aggressively marketed DPs as an opportunity to cross-sell other banking products, approaching the DP as a gateway to a comprehensive, long-term banking relationship. It is common to see DP proposals require opening a new account with minimum balance in order to receive the rate and term offered on the DP.

ACTION REQUIRED

Issuers and borrowers should revise their written post-issuance compliance procedures to incorporate the effects of the two new material events notices to the Rule. We suggest including:

- identification of the new material events
- a process to maintain a catalogue of financial obligations, determine their materiality and identify which outstanding CUSIPs will need to be filed against when posting notices regarding such financial obligations to EMMA
- a process to evaluate whether any "defaults" have occurred on financial obligations that would be subject to disclosure under the Rule
- a determination of whether operative documents related to financial obligations can be posted when required or whether a summary of such financial obligation should be filed instead

In addition, we suggest reviewing your existing continuing disclosure agreements to determine whether they have terms that automatically amend the document to reflect changes to the Rule. If so, you will need to treat such continuing disclosure agreements as if they were effected on February 27 and comply with the amended Rule for the affect series of bonds.

If you subscribe to our **Muni**Vault® service, we will be providing you with proposed changes to your post-issuance compliance procedures in the coming weeks. We will also provide you with a template to catalogue any financial obligations, as well as a model term sheet to summarize these financial obligations for posting to EMMA when necessary.

If you do not subscribe to our **Muni**Vault® service, we'd love to help. I've conveniently included a brief commercial below.

Under the amendments to the Rule, municipal security dealers are obligated to undertake due diligence to ensure issuers and borrowers have complied with the Rule's financial obligations events notices. Unlike postings regarding ratings changes or defeasances or draws on reserve funds—all binary (they either happened or they didn't)—issuers' and borrowers' decisions regarding which instruments are financial obligations and which of those are material may be subject to some debate. We encourage you to be thoughtful and thorough in your analysis and to be prepared to discuss and defend your choices with dealers and their counsel during the underwriting process.

Columbia Capital created its **Muni**Vault® service to ease the administrative burden of post-issuance compliance on municipal bond issuers and borrowers and to provide a streamlined, secure, cloud-based approach to ensuring on-going compliance with post-issuance compliance policies and procedures. For more information, browse to **getmunivault.com** or send us a note at **getmunivault@columbiacapital.com**.

CONCLUSION

Although the revised Rule is only about a dozen sentences long, it has the potential to create significant challenges for issuers and borrowers, especially those with complex debt portfolios. Unlike other material events subject to the Rule which provide bright line clarity for when EMMA disclosure is required, these additions will require review of your portfolio of debt and debt-like instruments and a thoughtful evaluation of whether those instruments rise to the level of materiality for disclosure purposes.

Jeff White, Managing Member
Columbia Capital Management, LLC

Disclosure: we're not lawyers and the foregoing is not legal advice. Neither are we accountants or auditors and the foregoing is not tax advice. Particularly with respect to

questions related to securities law or Federal tax regulations, we encourage you to seek advice and counsel from bond counsel, general counsel/city or county attorney, your auditors or other experts in these fields.