February 28, 2019

Reminder re Effective Date of Additional Material Events Reporting under SEC Rule 15c2-12

Effective as of February 27, 2019, tax-exempt borrowers entering into new continuing disclosure agreements and who also have bank loans, bank purchases of tax-exempt bonds, other private placements, or leases that function as debt must meet incremental reporting requirements.

In August, the Securities and Exchange Commission ("**SEC**") finalized an amendment to Rule 15c2-12 under the Securities Exchange Act of 1934 ("**Rule 15c2-12**" and the "**Exchange Act**"), adding two new events for which conduit borrowers will be required to provide continuing disclosure about the material terms of certain arrangements and adverse events related to financial difficulties (the "**Final Rule**").

The two new material events add to the fourteen[1] existing material events. They are:

"(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; and

(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 additional events do not apply automatically to existing continuing disclosure agreements or existing arrangements. They must be incorporated into new continuing disclosure agreements for tax-exempt bonds issued on or after February 27, 2019 (the "**Effective Date**").

Borrowers will have ten business days after the event within which to make such assessments before an event notice is due on EMMA. This alert helps to identify key assessment factors and highlights challenges that may arise for borrowers in assessing whether disclosure is required under each new event.

First New Disclosure Event: Incurrence of Financial Obligations and Agreement to Covenants

The Final Rule adds a requirement for notice of (i) the incurrence of a financial obligation of the issuer or obligated person, if material, or (ii) 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.

Under the Final Rule, the term "financial obligation" covers, if material:

- All debt obligations, short term as well as long term, including lease arrangements entered into as vehicles to borrow money;
- Derivative instruments entered into in connection with, or pledged as security or a source of payment for, existing or planned debt obligations, including forward-starting swaps and rate locks; or

[1] *See* 17 C.F.R. § 240.15c2-12(b)(5)(i)(C). These events are limited to those affecting tax-exempt bonds and notes subject to Rule 15c2-12 and include, for example, principal or interest payment delinquencies; non-payment-related defaults, if material; unscheduled draws on debt service reserves reflecting financial difficulties; modifications to rights of security holders, if material; rating changes; and bankruptcy, insolvency, receivership or similar events involving an obligated person.

- Guarantees of either of the preceding.

Borrowers may find it helpful to fully disclose all existing bonds and credit agreements as of the date of any new continuing disclosure agreements after the Effective Date, so as to define which financial obligations are considered material and thereby limit the potential universe of future disclosure regarding these obligations.

Leases

Importantly, in a change from the proposed amendment, leases are not automatically covered. The SEC omitted leases as "financial obligations" under the Final Rule because it agreed with commenters that including material leases would impose a disclosure requirement in too broad a range of circumstances. Leases are not entirely excluded, however. The SEC stated in the Final Rule that a lease arrangement entered as "a vehicle to borrow money" should be treated as a financial obligation subject to disclosure if material.[2] Borrowers thus will face the need to decide whether a given lease operates as a "vehicle to borrow money," and should consider how their leases would be treated under this standard.

Derivatives

"Financial obligations" subject to the Final Rule will include derivative instruments when "entered into in connection with, or pledged as security or source of payment for, an existing or planned debt obligation."[3] The definition captures swaps, security-based swaps, futures contracts, forward contracts, options, any combination of the foregoing and similar instruments to which the borrower is a counterparty related to an existing or planned debt obligation of the borrower or a third party, if material. The SEC advises that derivative instruments designed to mitigate investment risk are not covered. Thus, borrowers subject to Rule 15c2-12 will wish to sort their derivatives into those designed to hedge against risks related to debt instruments or, alternatively, to hedge against investment risk. Planned hedges, such as forward-starting interest rate swaps, as well as swaps entered into at the same time as related debt obligations, are covered.

Short-term Debt

The SEC advises in its commentary to the Final Rule that short-term as well as long-term debt could be covered by the definition of financial obligation. Thus, in any analysis to determine whether an instrument constitutes a financial obligation, the duration of the debt should not be considered a factor.

Guarantees

The SEC advises that a guarantee of a debt obligation or a debt-related derivative instrument can raise two disclosure obligations under the Final Rule, one for the guarantor and one for the beneficiary of the guarantee. Whether the borrower is the beneficiary of another's guarantee or is itself the guarantor, the borrower's exposure to the credit of another entity must be evaluated and, if material, the existence of the guaranty must be disclosed.

New Covenants, Etc.

The Final Rule does not provide specific guidance regarding what will be considered an "agreement to covenants" requiring disclosure. Borrowers thus face the task of evaluating the interaction of financial obligations with bond covenants and default provisions. For instance, to assess whether covenants in financial obligations other than bond documents may create risks for disclosure consideration, particular attention should be paid to financial ratios and other

[2] 83 Fed. Reg. 44700, 44711 (Aug. 31, 2018).
[3] *Id*. at 44712.

covenants that may cause cross-defaults under bond documents. Borrowers must evaluate these developments under the materiality standard to determine whether disclosure is required.

Materiality Standard

As noted, the new disclosure requirement regarding financial obligations is subject to a materiality standard. Determining materiality, then, will be an integral part of assessing whether a new financial obligation must be disclosed to the market through a material event notice posted to EMMA.

Following long-standing policy, the SEC declined to provide a mechanical test for determining the materiality of a financial obligation and has reiterated that the materiality determination "should be based on whether the information would be important to the total mix of information made available to the reasonable investor."[4] This is the same standard that applies to materiality determinations for official statements and other continuing disclosure postings. In comments, the SEC observed that not all financial obligations are material. Materiality assessments, we advise, should look to the borrower's facts and circumstances, and may take into account a variety of factors such as amount (individually as incurred and in the aggregate with several similar or related obligations and future draw-downs), exposure through cross-defaults to the terms of other debt, covenants that could trigger defaults, senior vs. subordinate lien status, rights and remedies of secured parties in pledged collateral and other dimensions that impact the obligated person's creditworthiness or liquidity or affect security holders.

Some borrowers may determine that the simplest course is to post the other financial obligations (presumably redacted for pricing and other confidential information), rather than attempting to assess whether the obligation is "material." However, doing so may result in setting the "floor" for negotiation with future lenders, and thus may be undesirable as a business matter. Borrowers should review the confidentiality provisions of these agreements before posting anything to EMMA.

Ten Business Day Deadline

The ten business day clock for assessing and disclosing material financial obligations and their terms starts running from the time when the obligation is incurred and enforceable, not from when any funds are drawn at a later date.

Second New Disclosure Event: Default or Other Events Reflecting Financial Difficulties

The second new event requiring disclosure also consists of a twofold test: (1) the occurrence of default or an event of default, an event of acceleration, a termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, (2) any of which *reflect financial difficulties* of the borrower.

Borrowers have for many years been required under Rule 15c2-12 to report a number of adverse events with respect to their tax-exempt debt, including principal and interest payment delinquencies, material defaults under other covenants, and unscheduled draws on debt service reserves and credit enhancements reflecting financial difficulties. Now, under the Final Rule, borrowers must also report the occurrence of similar events under other financial obligations if they reflect financial difficulties. Note that these disclosure requirements will apply to financial difficulties related to any financial obligations of borrowers, not only those incurred after the Effective Date. These are "early warning" requirements and will impose an obligation to monitor all debt-related obligations for compliance well ahead of matured events of default. Nuances to bear in mind include assessing whether waivers of covenant noncompliance, amendments to debt terms or extensions or renewals of existing debt are related to financial difficulties, in which case they are, the SEC advises, reportable as modifications of terms. Given the "financial difficulties" test, general materiality is not relevant to the second new material event cluster.

[4] *Id*. at 44705-06.

Recommendations

The addition of these two new disclosure events will require a significant change to compliance and reporting processes for any tax-exempt borrowers that issue new bonds after the Effective Date or that are subject to existing continuing disclosure undertakings that incorporate these changes by reference. Such borrowers should remember to consider a continuing disclosure posting any time they engage in a public offering of taxable bonds or a private debt-type transaction, including leases that could be considered vehicles to borrow money. In addition, borrowers must keep in mind that the content of such disclosure is subject to compliance with Rule 10b-5 under the Exchange Act, necessitating an additional analysis of whether such disclosure contains any untrue statements of material fact or omits to state any material facts necessary to make the statements, in the light of the circumstances under which they were made, not misleading. Such borrowers should also keep in mind that, because these amendments apply to future obligations, the Final Rule will result in inconsistent continuing disclosure requirements for borrowers with continuing disclosure obligations on bonds that predate the Effective Date. If administratively preferable, borrowers can, of course, make matching voluntary disclosures for older debt to which the new regulatory disclosure categories do not apply.

As a best practice, borrowers negotiating new credit arrangements should bear the disclosure requirements in mind, negotiate exclusions from confidentiality restrictions and agree with counterparties on the scope of disclosure of specific terms, for example by simply uploading a redacted credit agreement or term sheet or posting summaries of terms. Finally, borrowers should expect heightened attention to their financial obligations throughout the due diligence processes of underwriters of public bond offerings and counsel to such underwriters.

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Please contact your usual Ropes & Gray attorney if you wish to discuss these changes in more detail or would like assistance in considering their application to your institution.