

*NAHEFFA Fall 2020 Virtual Conference*

# CONTINUING DISCLOSURE IN AN UNCERTAIN ENVIRONMENT

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# Why is Continuing Disclosure Necessary?

- SEC imposes obligations on broker-dealers to obtain from issuers a commitment to disclose in publicly offered bond transactions
- When speaking to the market, all “material” information must be disclosed
- Policy: Parties buying municipal securities in the secondary market should have access to information necessary to make an informed investment decision

# Rule 10b-5 and Section 17(a)

## Rule 10b-5 (under the Securities Exchange Act of 1934)

“It shall be unlawful for any person . . .

- to employ any device, scheme or artifice to defraud,
- to make any untrue statement of a **material** fact or to omit to state a **material** fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .”

Requires “scienter” – an intent to deceive or defraud, including acting recklessly

# Rule 10b-5 and Section 17(a)

## Section 17(a) (under the Securities Act of 1933)

- Similar to Rule 10b-5 but can only be used by the SEC, as opposed to private investors
- Must be “in connection with the purchase or sale of any security”
- Violation can be based on negligence, rather than intention to defraud

# The “Materiality” Standard

## Materiality

- “[w]hether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest”
- Materiality is determined in context of all the facts and circumstances, including the “total mix” of information available
- Guidance comes primarily on a retroactive and fact-specific basis from court decisions and SEC enforcement cases; SEC will not provide advance guidance

# When do disclosure rules apply?

- Rule 10b-5 applies whenever an issuer is “speaking to the market”
  - Official Statements for new offerings
  - reporting under a Continuing Disclosure Agreement
  - voluntary filings on EMMA
  - Almost any statement or document with financial information, such as
    - ✓ Public statements by officials, including speeches, social media, media interviews
    - ✓ Investor website – be careful about hyperlinks or dated information
    - ✓ Public reports, like a CAFR or report submitted to another government agency or legislative body or application for financial assistance

# Basics of Post-Issuance Disclosure

- Unlike corporate debt, municipal bonds are not subject to the registration requirements of the Securities Act of 1933, so municipal Official Statements are not submitted for approval by the SEC and municipal issuers have no obligation for ongoing disclosure under the Securities Exchange Act of 1934.
- Tower Amendment of 1975 prohibits the SEC or the MSRB from pre-review of municipal disclosures.
- By the 1980s the SEC was concerned with lack of post-issuance disclosure in the muni market. Investors seeking to trade bonds of smaller issuers which do not come to market frequently had no reliable way to understand their current financial condition.

# Basics of Post-Issuance Disclosure

- SEC created a “work-around” by using its authority to regulate municipal securities dealers by adopting Rule 15c2-12.
- As amended in 1995, the Rule requires any underwriter of a publicly-offered bond to be sure that the issuer signs a contract, enforceable by a trustee or bondholders, called a Continuing Disclosure Agreement or Undertaking (“CDA” or “CDU”), to provide certain information for the life of the bonds and post it on a public forum.
- That forum is now a website operated by the MSRB called the Electronic Municipal Market Access site, or EMMA.



# Basics of Post-Issuance Disclosure

- A CDA must include:
  - An annual financial report including most recent audited financial statements, to be filed by a date selected by the issuer not more than one year after the end of its fiscal year.
  - Notice of the occurrence of any of 16 events, to be reported within 10 business days of the occurrence.
    - Some of the events must be reported only if they are **deemed material** to bondholders; the others must be reported in all cases because the SEC deemed them to always be material.
    - A complete list of the 16 events is contained as Exhibit A to this slide deck.
    - Later in this program we will drill into the two most recently added events, which became effective for CDAs signed after February 27, 2019.

# Policies and Procedures

- Given the wide variety of means by which an issuer may be speaking to the market, in order to minimize potential liability it is best practice to adopt disclosure policies and procedures and follow them.
- This will help an organization maintain consistency in disclosing financial and operating information and ensuring its accuracy, both for primary and secondary market disclosure.
- Procedures should identify one official or office responsible for disclosure and make all relevant parts of the organization coordinate information dissemination through that office.
- Regular training on disclosure rules and procedures should be implemented for all personnel regularly involved in any disclosure activity.
- It is important to make sure all the “right people are in the room.”

# COVID-19

## What Disclosures Should I Make?

- If an issuer is in the market with a new issue or making a required post-issuance report, some discussion of COVID-19 impact will be necessary.
- SEC has urged issuers of municipal securities to provide investors with as much information about their current financial and operating condition as is reasonably practicable. Depending on the circumstances, disclosure should be issuer-specific or security-specific, or both. The typical process to provide backward-looking data may be inadequate in current conditions.
- While information about future impact of COVID-19 is likely based on estimates and assumptions, the SEC believes such information is beneficial to investors.

# COVID-19

## SEC Statement issued May 4, 2020

- In a Statement issued May 4, 2020 (the “Statement”), the Chairman of the SEC and the Director of the SEC’s Office of Municipal Securities urged issuers to provide COVID-19 information both in required disclosures as well as voluntary disclosures on EMMA.
- The Statement recognized that making disclosures in an uncertain environment, particularly on a voluntary basis, is challenging and could be viewed as risky. The Statement offered suggestions to offset the risks.

# COVID-19

## SEC Statement issued May 4, 2020

- » provide meaningful cautionary language (describe relevant facts and assumptions; note that some information may be incomplete or unknown, and describe methodology used to produce in the information)
- » look to information contained in government reports or applications for financial assistance – make sure of consistency across all sources

# COVID-19

## SEC Statement issued May 4, 2020

- The Statement noted that municipal issuers could not use certain statutory safe harbors applicable to corporate entities for making “forward-looking statements.” However, the Statement noted that there was a judicially-created “bespeaks caution doctrine” which had a similar effect, which municipal issuers could use. This requires a forward-looking disclosure to spell out its limitations, assumptions and risks.
- The Statement explicitly stated: **“We would not expect good faith efforts to provide appropriately framed current and forward-looking information to be second guessed by the SEC.”**

# COVID-19

- Such advance notice is virtually unprecedented, and no doubt has encouraged considerable voluntary disclosures on COVID 19. Although Rule 10b-5 does still apply, the SEC suggests a well-developed disclosure would avoid any finding of scienter.
- Data from the MSRB shows that thousands of COVID related disclosures are being made.

# New “Listed Events”

- In August 2018, the SEC amended Rule 15c2-12 to add two new Listed Events.
- **Compliance Date: February 27, 2019**
- These two new events must be included in any new Continuing Disclosure Agreement (“CDA”) executed on or after the Compliance Date
- The two new events **do not apply** retroactively to CDAs in existence prior to the Compliance Date, although some aspects of the new Listed Events are retroactive.



# New “Listed Events”

## “Listed Events” (15) and (16)

- 15) incurrance 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** (emphasis added)
- 16) default, event of acceleration, termination event, modification of terms or other similar events under a financial obligation of the obligated person, any of which **reflect financial difficulties** (emphasis added)

# New “Listed Events”

- According to SEC News Release, the adopted amendments “focus on material financial obligations that could impact an issuer’s liquidity, overall creditworthiness, or an existing security holder’s rights”
- Better inform investors and market participants about non-public debt and financial condition of issuers of municipal securities
- The SEC issued an Adopting Release in August 2018 which provides additional explanation of certain terms used in the amended Rule
- Even with this Adopting Release and informal SEC staff guidance in subsequent webinars and conferences, there remain many open issues in the interpretation and implementation of the new listed events

# Financial Obligation

## New Defined Term – “Financial Obligation”

**“Financial Obligation” is defined as 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) a guarantee of either (i) or (ii)

- According to the Adopting Release, the term focuses on debt, debt-like or debt-related obligations of issuers
- The term does not include municipal securities as to which a final official statement has been provided to the MSRB consistent with Rule 15c2-12 (e.g. posted on EMMA and having an effective CDA).

# Listed Event (15)

**(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**

**Scope of Event Reporting (Part 1):** Under CDAs entered on or after the Compliance Date, applies to new, material financial obligations incurred on and after the date the CDA was entered

# Listed Event (15)

**Scope of Event Reporting (Part 2):** Also applies to any agreement to new and material covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation agreed to by the issuer, which may affect security holders of debt to which any CDA relates.

- This second part of event (15) can be retroactive, by requiring reporting of material changes to any financial obligation whether incurred after or before the date of new post-Compliance Date CDA.

**Incurrence of Financial Obligation:** A financial obligation generally should be considered to be incurred when it is enforceable against an issuer

# Listed Event (15)

**Timing** – Event Notices must be filed within ten business days of date the “financial obligation” is incurred

- Series of Financial Obligations – consider all relevant facts and circumstances
  - Shared authorizing document; same/similar purpose; same source of security
- Lines of credit, draw down bonds or commercial paper only need to be reported once, when the debt is legally enforceable (whether or not any funds are immediately drawn or borrowed) and not on each draw or CP issuance, as long as the initial reporting contains all the material terms of the borrowing program.
- Debt obligations are reported when actually issued, not when sold.

# Listed Event (16)

**(16) default, event of acceleration, termination event, modification of terms or other similar events under a financial obligation of the obligated person, any of which reflect financial difficulties (emphasis added)**

**Scope of Event Reporting:** Any event of the type set out in (16) that occurs under the terms of a financial obligation must be disclosed regardless of whether such financial obligation was incurred before or after the Compliance Date

# Listed Event (16)

**“Reflect Financial Difficulties”** – concept used since adoption of Rule 15c2-12; existing disclosure events including unscheduled draws on debt service reserves (3) and unscheduled draws on credit enhancements (4)

- As used in connection with new events, concept covers a broad potential series of actions and implies an element of materiality
- Analysis for reporting (similar to event (15)), consider whether the event may have potential adverse impact on the liquidity and overall creditworthiness of the issuer or affect security holders to which a CDA relates



# Listed Event (16)

“**Default**” – can be monetary default (failure to pay principal/interest or other funds due) or failure to comply with specific covenants

“**Other Similar Events**” – broad concept to capture circumstances that reflect financial difficulties even if they do not qualify under any of the other types of events

# What is a “Financial Obligation”

“**Financial Obligation**” is defined as 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) a guarantee of either (i) or (ii)

**Debt Obligation:** any short-term or long-term debt obligation under the terms of an indenture, loan agreement, lease, or similar contract which represents a borrowing of money to be repaid at a later date

- Focus on obligations and terms that could adversely affect rights of existing security holders or impact the liquidity or creditworthiness of an issuer
- The term is **broader than state law definition of debt**. Not limited to general obligation or ad valorem tax debt. Includes revenue transactions and subject to appropriation financings

# What is a “Financial Obligation”

“Financial Obligation” is defined as 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) a guarantee of either (i) or (ii)

- Any swap, security-based swap, futures contract, forward contract, option or similar instrument (or combination) to which an issuer is a counterparty
- Focus on exposure to contingent liquidity risk (e.g. collateral postings and termination payments) which could adversely impact liquidity or creditworthiness or affect interests of security holders
- Does not cover derivative instruments designed to mitigate investment risk not related to a particular debt issue

# What is a “Financial Obligation”

“**Financial Obligation**” is defined as 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) **a guarantee of either (i) or (ii)**

- May trigger two reporting requirements:
  - When an issuer is acting as a guarantor for the payment of a financial obligation; and
  - When an issuer is the beneficiary of a guarantee of a third party relating to a financial obligation, may be reportable as a material term of the financial obligation

# What is a “Financial Obligation”

If in doubt whether a new financial arrangement is covered under Event (15), better to disclose it, subject to a materiality analysis.

# What is a “Financial Obligation”

## Examples of Financial Obligations

Direct Purchase Loans	Bank Loans	Lines / Letters of Credit Liquidity Facilities
Private Placements	Standby Bond Purchase Agreements	Leases that operate as vehicles for borrowed money
Certificates of Participation	State sponsored loans (water, sewer, etc.)	Derivatives (i.e. Interest Rate Swaps, Caps, Futures, etc.)
Commercial Paper Programs	Federal / State Programs (i.e. Municipal Liquidity Fund, CARES Act)	Financial Guarantees

# Underwriter Considerations

- Issuer awareness of underwriter considerations – Understand approach of underwriters to verifying that issuers have complied with the new rules once deals are offered after February 27, 2019:
  - Rule 15c2-12 require underwriters to independently investigate an issuer’s compliance with its CDA over the past 5 years.
  - For first deal after March 2019, when event notices (15) and (16) have not yet been in place, underwriters may want to see new policies and procedures to confirm appropriate internal controls will be in place
  - For subsequent deals, they will need to determine if event (15) or (16) has occurred and was reported within 10 business days

# Underwriter Considerations

- There may be disagreement about whether an arrangement was a material financial obligation or whether an event reflected financial difficulties. It will be helpful if the issuer can explain why it made a decision not to report, based on a memorandum to the file at the time the possible event occurred.
- Underwriters are still gun shy after MCDL because they are under SEC consent decrees and risk large fines if found to have failed in their obligations.



# Underwriter Considerations

- Underwriters will still be inclined to require an issuer, if necessary, to make a retroactive filing under Event (15) or (16) and disclose that in the upcoming official statement.
- This tension will be minimized by reporting the event in the first place if it is in a grey area.

# Considerations for New Listed Events

- Make sure your policy and procedures are updated accordingly.
- When feasible, prepare an inventory / spreadsheet of outstanding financial obligations:
  - Identify counterparty, par amount, amortization schedule, interest rate, default provision, security pledge, etc.
  - Determine which financial obligations are deemed “material”
  - Maintain and update list accordingly for new “financial obligations” and changes to existing “financial obligations”

# Considerations for New Listed Events

- Discuss in advance how to report on a new, material financial obligation:
  - provide a summary of material terms; or
  - post a copy of the complete loan document with deletion of confidential terms (e.g. phone or fax numbers, account numbers, etc.)
- Experience since March 2019 is that a vast majority of event (15) filings just attach the relevant loan document with appropriate redactions, although if this is lengthy, it is not as useful to investors.
- Preparing a summary creates legal risks, unless the entire document is also posted (which is permitted)

# Consequences of Failure to Comply

- Non-compliance with any part of a CDA, including Events (15) and (16), is not an “Event of Default” under bond documents but bondholders have right to sue for compliance with continuing disclosure obligations
- Issuers must disclose a material failure to comply with its CDAs in future Official Statements for 5 years following the failure
- Can give rise to a securities law fraud case if there is a misstatement or omission about past compliance in an offering document
- No clear guidance on what is a “material” failure to comply, especially as to late filings. Underwriters now insist on listing any non-compliance, even if seemingly trivial

# Types of SEC Enforcement Actions

Since the mid-2000s, the SEC has ramped up enforcement focused on the municipal market

- Inadequate Pension Disclosures
- Misleading or Incomplete Financial Disclosures
- Failure to disclose the use of unusual accounting actions
- Failure to disclose shortcomings in economic development projects
- Failure to disclose financial or legal risks
- Failures of Continuing Disclosure



## CONTACT INFORMATION

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# EXHIBIT A

LISTED EVENT NOTICES



## Listed Events that require notification within ten (10) business days:

- 1) Principal and interest payment delinquencies;
- 2) Nonpayment related defaults, **if material**;
- 3) Unscheduled draws on reserve reflecting financial difficulties;
- 4) Unscheduled draws on credit enhancement reflecting financial difficulties;
- 5) Substitution of credit or liquidity provider or failure to perform;
- 6) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other **material** notices or determinations with respect to the tax status of the security, or other **material** events affecting the tax status of the security;





## Listed Events that require notification within ten (10) business days (cont.):

- 7) Modification to rights of security holders, **if material**;
- 8) Bond calls, **if material**, and tender offers;
- 9) Defeasances;
- 10) Release, substitution or sale of property securing repayment of the security, **if material**;
- 11) Rating changes;
- 12) Bankruptcy, insolvency, receivership, or similar event of an obligated person;



## Listed Events that require notification within ten (10) business days (cont.):

- 13) The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, **if material**;
- 14) Appointment of a successor trustee or change in name of a trustee, **if material**.



## Listed Events that require notification within ten (10) business days (cont.):

- 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 a financial obligation of the obligated person, any of which reflect financial difficulties



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