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Client Advisory re: Rule 15c2-12 Amendment

An amendment (the "Amendment") to Rule 15c2-12 ("Rule 15c2-12") of the U.S. Securities and Exchange Commission (the "SEC") will take effect on February 27, 2019. The Amendment will affect public issuers of municipal securities. We are writing to brief you on the general nature of the Amendment, to explain how it may impact the marketing of your future bond and note issuances, and to suggest that you take this time to implement internal procedures that will ensure your ability to comply with these new requirements once they become effective.

Background

Rule 15c2-12 applies to public offerings of municipal securities (both long-term bonds and short-term notes) for which an official statement or similar disclosure document (the "Official Statement") is utilized. (Many privately-placed bonds and short-term note issues are exempted from Rule 15c2-12 and are marketed without an Official Statement.) As currently in effect, Rule 15c2-12 requires that the underwriter (in a negotiated sale) or each bidder (in a competitive sale) ensure that the public issuer will enter into a continuing disclosure undertaking for that issue (the "Undertaking") to provide ongoing information to the Municipal Securities Rulemaking Board (the "MSRB") for the benefit of investors. In addition, the Official Statement must disclose all instances during the past five years in which the public issuer has failed to materially comply with any previous Undertaking.

Each Undertaking must include a requirement that the public issuer promptly (i.e., within ten business days) notify the MSRB following the occurrence of any of twelve enumerated events (the "Notice Events"). For long-term public offerings, the Undertaking must also obligate the public issuer to provide annual updates of the financial information and operating data included in the Official Statement, along with copies of audited (and in certain cases, unaudited) financial statements when available (collectively, the "Financial Information"). Public issuers often retain disclosure agents and/or municipal advisors to assist in the timely filing of Notice Events and Financial Information, and to help ensure that any instances of material noncompliance are appropriately disclosed.

Prior to purchasing or bidding on municipal securities, an underwriter or bidder must form a reasonable basis to conclude that the public issuer will comply with the Undertaking about to be entered into for that issue. An underwriter must also confirm that any instances of material noncompliance with prior Undertakings are appropriately disclosed. In past years the SEC has taken enforcement actions against a number of investment banks, and some public issuers, for failure to comply with Rule 15c2-12. While the public issuer is responsible for ensuring compliance with all of its Undertakings, underwriters and bidders generally undertake pre-sale diligence to confirm such compliance (or disclosure of material non-compliance), and bidders may refrain from bidding on competitive offerings where they cannot readily confirm past compliance by the public issuer.

The Amendment

The Amendment adds two new Notice Events that must be included in all Undertakings entered into on or after February 27, 2019. In substance they are:

1. entering into any new financial obligation, derivative or guaranty, if it is "material"; and

2. any default, modification, waiver, etc., to any financial obligation, derivative or guaranty (including those entered into prior to February 27, 2019), if it "reflects financial difficulties".

Financial obligations may include bonds and notes, as well as other financial transactions that might be considered debt-like (such as financing leases and lease-to-own arrangements). Derivatives may include interest rate swaps, interest rate lock agreements and forward bond purchase agreements. Guarantees may include service contracts or deficiency agreements relating to authorities and their debt obligations.

Practical Impact of the Amendment

Over the years, public issuers have developed formal or informal diligence procedures for ensuring that the occurrence of any Notice Event is made known to the responsible financial officer, so as to result in the timely filing with the MSRB of any required notice. Similarly, underwriters and bidders have developed protocols by which a public issuer's compliance can be assessed. The existing Notice Events mostly consist of extraordinary events that are likely to be known readily by the responsible financial officer (e.g., defaults, modifications, defeasances, bankruptcies, adverse tax opinions). One Notice Event (rating changes) can be readily confirmed by reference to rating agency websites.

The two new Notice Events present new diligence and disclosure challenges. As discussed below, a number of financial transactions will now require the timely filing of "incurrence" notices, and events relating to existing financial transactions will now require the timely filing of "default/modification/waiver" notices. Public issuers should consider updating their internal procedures so that (1) the occurrence of any of the new Notice Events can be quickly evaluated for a determination as to whether a notice must be filed (so that the notice, if required, can be filed within the ten business day timeframe), and (2) underwriters and bidders may, in part, rely on the existence of such public issuer procedures as part of their own diligence obligations under Rule 15c2-12.

Public issuers are not required to actually make the new Notice Event filings until after they have entered into a new Undertaking in connection with bonds or notes issued on or after February 27, 2019. However, internal procedures should be updated by the time such bonds are notes are issued.

Observations on the New "Incurrence" Events

Although "incurrence" notices are only required if the incurrence of a financial obligation, derivative or guaranty is "material", given the looseness of that standard and the stakes involved, it would be prudent to presume that all incurrences are material, and therefore would require a Notice Event filing.

Depending on the circumstances, the following financial transactions may be considered to be the incurrence of a "financial obligation" that would require a Notice Event filing:

- Issuance of short-term debt (including bond anticipation notes) without an Official Statement
- Closing on a construction loan or permanent financing with the NJ Infrastructure Bank
- Closing on a Green Acres or other loan from the State of New Jersey or any state/federal agency
- Closing on a bank loan or other private financing
- Closing on a capital lease (including vehicle/equipment leases) where title is obtained at the end

The above examples are neither exhaustive nor definitive. The SEC has already provided some guidance as to which types of transactions constitute "financial obligations", and may be expected to provide additional guidance from time to time. We suggest that you consult with bond counsel in the event of any uncertainty as to how a particular transaction would be treated under the Rule.

Most public issuers will not incur any "derivatives", but please note that certain forward bond purchase contracts may fall within that definition where the underwriter pays an up-front amount and is entitled to damages if the public issuer does not later issue the future refunding bonds.

Municipalities and counties have the power to guaranty the obligations of certain other public issuers. For example, each can guaranty the bonds of a county improvement authority, and municipalities can guaranty the bonds of a parking authority or municipal port authority. In addition, municipalities can guaranty certain other types of revenue bonds, including "redevelopment area bonds" that are otherwise payable from PILOT payments. All such transactions would likely constitute "guarantees" under the Rule.

In addition, municipalities and counties are often parties to open-ended service contracts or deficiency agreements with their sewerage or utilities authority or with a regional water or sewer authority or commission of which they are a member or participant. Depending on the circumstances (including whether the authority or commission is issuing its own Official Statement in connection therewith), the incurrence of a "financial obligation" by an authority or commission entitled to the benefit of a municipal or county service contract or deficiency agreement may be considered to be the incurrence of a new "guarantee" by that municipality or county. It would therefore be prudent for municipalities and counties to institute procedures that would ensure prompt notice whenever any of its authorities or commissions incurs a "financial obligation".

Observations on the New "Default/Modification/Waiver" Events

These events are sufficiently rare, and notable, that the responsible financial officer will be aware of most of these events, and will therefore be in a position to ensure timely filing of any required event notice. However, one area may warrant consideration:

- Bank loans and capital leases may contain interest rate or maturity schedule readjustments resulting from a credit rating downgrade, failure to maintain a certain financial ratio, or changes in law affecting the after-tax return to the bank or lessor. In those instances, a readjustment attributable to the financial standing of the public issuer may be considered to be a modification reflecting financial difficulties that would require a Notice Event filing.

This Client Advisory is provided as a brief summary of certain provisions of law that may be of interest to our clients. This Client Advisory should not be considered to be legal advice. Future changes in law (or interpretations thereof) may alter some of the observations and suggestions noted above. Please contact Meghan Clark (732-530-8822) or Jim Fearon (609-278-3902) for a more complete explanation of the Amendment and to answer any questions you may have.

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