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Living with SEC rule 15c2-12 municipal securities disclosure amendments

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The U.S. Securities and Exchange Commission ("SEC") recently adopted amendments to Rule 15c2-12 (the "Rule"), effective for municipal securities offerings with continuing disclosure undertakings entered into on or after February 27, 2019. The amendments effectively require the securities' issuers to contract to provide prompt public notice of new financial obligations and terms, if material, as well as related defaults and similar events that reflect financial difficulties, while the securities remain outstanding. The amendments will impose significant and uncertain new burdens on municipal securities issuers, conduit borrowers, underwriters, and brokers. We explore ambiguities and challenges posed by the amendments and how to meet them.

Summary

- **Issuers/obligated persons:** To issue municipal securities in an offering with a continuing disclosure undertaking that is required by the Rule and is entered into on or after February 27, 2019, issuers or obligated persons will need to:
  - undertake to give prompt notice whenever they (a) incur or agree to modify terms of debt or debt-like obligations (other than municipal securities for which a continuing disclosure agreement is entered into and an official statement is filed with the MSRB), derivative instruments, or guarantees of either, if material, or (b) default, encounter similar events, or receive waivers with respect to any such obligation that reflects or results in financial difficulties,
  - revise or adopt continuing disclosure practices to enable them to learn of, recognize, and give prompt notice of any of these new events, and
  - disclose in future offerings any material breach of the undertaking (as they now do for prior undertakings) in the prior 5 years.

- **Underwriters:** To participate in primary offerings of municipal securities with a continuing disclosure undertakings that are required by the Rule and entered into on or after February 27, 2019, underwriters will need to:
  - Confirm that the continuing disclosure undertaking conforms to the requirements of the Rule as amended, and
  - Update their policies and procedures for confirming that the undertakings are likely to be performed and, in the case of a second or later offering by an issuer or obligated person, that no undisclosed material breaches of prior undertakings occurred in the prior 5 years.
- **Municipal advisors:** To participate in competitive offerings of municipal securities with continuing disclosure undertakings that are required by the Rule and entered into on or after February 27, 2019, municipal advisors should update their policies and procedures as described for underwriters, unless they do not participate in preparing the official statement or associate themselves with the offering. They should also update their policies and procedures for negotiated offerings, if any, in which they have assumed responsibility for the continuing disclosure descriptions in the official statement.
- **Broker-dealers:** Brokers, dealers, and municipal security dealers (whether or not underwriters) will need to update their policies and procedures for receiving prompt notice of any of the new events reported to EMMA and for disclosing them to customers at the time of trade.

Current rule

As first adopted by the SEC in 1989, the Rule required underwriters to obtain, review, and distribute an offering document (official statement) prepared by the issuer as a condition to participating in primary offerings of municipal securities that are not exempt from the Rule.[1] As subsequently amended,[2] the Rule imposed two additional conditions: (1) that the underwriter reasonably determine that the issuer or another obligated person has contracted (through a continuing disclosure agreement or "CDA") to provide to the Municipal Securities Rulemaking Board (the "MSRB"), for posting on its Electronic Municipal Market Access ("EMMA") system, certain annual financial and operating data and timely notice of any of 14 events[3] and (2) that the official statement describe the CDA and each material breach of such person's prior CDAs in the previous 5 years.[4] For simplicity, in this update we refer to the obligor on a CDA as the "issuer," whether the actual issuer of the related municipal securities or a conduit borrower or other "obligated person"[5] with respect to the securities.

The Rule also requires broker-dealers[6] to institute procedures to receive promptly any related event notice provided to the MSRB before recommending the purchase or sale of a municipal security.[7] Under MSRB rules, no broker-dealer may engage in a municipal securities transaction with a customer without disclosing all material information about the transaction that is known to the broker-dealer as well as all material information about the security that is reasonably accessible to the market, including through EMMA.[8]

Description of amendments

Effective for primary offerings of municipal securities with a CDA that is required by the Rule and entered into on or after February 27, 2019, the amendments add two additional events to those "with respect to the securities being offered" for which an issuer or obligated person must commit to provide timely notice to the MSRB in a qualifying CDA:

- (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.[9]

1 SEC Rel. No. 34-26985 (June 28, 1989); 17 C.F.R. §240.15c2-12(b)(1)-(4).
2 SEC Rel. No. 34-34961 (November 10, 1994); SEC Rel. No. 34-59062 (December 5, 2008); SEC Rel. No. 34-62184A (May 26, 2010).
3 17 C.F.R. §240.15c2-12(b)(5).
4 17 C.F.R. §240.15c2-12(f)(3) (definition of "final official statement").
5 Under the Rule, an "obligated person" is a person "committed by contract or other arrangement to support payment" of any part of the municipal securities being offered. 17 C.F.R. §240.15c2-12(f)(10).
6 As used herein, the term "broker-dealer" is intended to include brokers, dealers, and municipal securities dealers.
7 17 C.F.R. §240.15c2-12(c).
8 MSRB Rule G-47; *see also* Supplementary Material .04, which provides that broker-dealers must implement processes and procedures reasonably designed to ensure that material information regarding municipal securities is disseminated to registered representatives who are engaged in sales to and purchases from a customer.
9 17 C.F.R. §240.15c2-12(b)(5)(C)(15)–(16).

The Rule defines "financial obligation" for these purposes 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) guarantee of (i) or (ii)."[10] The term "financial obligation" excludes, however, municipal securities for which an underwriter has provided a final official statement to the MSRB in connection with a primary offering.[11]

Neither the words in the two new paragraphs (other than "financial obligation") nor the words used in the definition of that term are defined in the Rule. Many are explained in the adopting release (the "Release"),[12] but often in ways that differ from their common meaning.

Under CDAs complying with the Rule as amended, the issuer must contract to provide notice of any of the newly added events to the MSRB within 10 business days after the event occurs, including events after the CDA is entered into with respect to previously outstanding financial obligations.[13]

When are the amendments effective?

The amendments apply to CDAs that are required by the Rule and entered into on or after February 27, 2019.[14] To enable primary offerings of municipal securities that close after that date, CDAs may need to comply with the amendments (and be described in preliminary and final official statements), even if the securities sell and the official statement is issued before that date, depending on when issuers enter into the CDAs.

When issuing municipal securities, most issuers agree at the time of sale to enter into a CDA at or before closing, but do not execute and deliver the CDA until closing. To issue municipal securities that require a CDA and close on or after February 27, 2019, issuers must either (a) enter into a CDA that complies with the amendments or (b) enter into the CDA on or after the sale date and before February 27, 2019, rather than at closing.

Some issuers incorporate CDAs into their governing body's order, ordinance, or resolution authorizing municipal securities, which is adopted on or before the sale date, rather than executing a separate CDA at closing. Such issuers should be considered to "enter into" the CDA on the sale date.

10 17 C.F.R. §240.15c2-12(f)(11)(i).
11 17 C.F.R. §240.15c2-12(f)(11)(ii).
12 SEC Rel. No. 34-83885 (August 20, 2018), 83 Fed. Reg. 44700 (August 31, 2018)(the "Release").
13 17 C.F.R. §240.15c2-12(b)(5)(i)(C).
14 Release, 83 Fed. Reg. at 44717.

Consequently, CDAs entered into in this manner for sales before February 27, 2019, should not need to comply with the amendments, even if the sales close on or after that date.

Unless the CDA for a primary offering of municipal securities is entered into before February 27, 2019, the preliminary and final official statements for the offering must describe a CDA that complies with the amendments, even if they are posted (or the securities are sold) before February 27, 2019, unless the offering is exempt from the Rule.[15]

If an issuer remarkets municipal securities in a primary offering that settles on or after February 27, 2019, it will need to enter into a CDA that complies with the amendments, even if the securities were issued before that date (unless they were issued before December 1, 2010, and have remained outstanding in denominations of $100,000 or more with demand privileges exercisable at least once every nine months, or the remarketing is otherwise exempt from the continuing disclosure provisions of the Rule).[16]

If an issuer has an outstanding line of credit or CP program when it first enters into a CDA that complies with the amendments, it may be required to provide notice of each additional advance under the line or ramp up of its CP balance, if material, pending further guidance from the SEC. (See "Drawdown bonds/CP/lines of credit" below.)

The amendments do not require issuers to amend their existing CDAs, or to enter into CDAs that comply with the amendments before February 27, 2019, nor do they require issuers to provide notice of the incurrence or amendment of material financial obligations or defaults, modifications, or similar events reflecting financial difficulties until after they enter into a CDA that complies with the amendments. However, once an issuer enters into a CDA that complies with the amendments, it will be obligated to provide notice of material amendments to financial obligations, and defaults and similar events under financial obligations that reflect financial difficulties, even for financial obligations incurred before the CDA is entered into.[17]

15 Id
16 See 17 C.F.R. §§240.15c2-12(b)(5)(i), (d)(5).
17 Release, 83 Fed. Reg. at 44716–17. The Release makes this point clearly for modifications and similar events reflecting financial difficulties, even though the paragraph of the Rule listing the two new events refers to events "with respect to the securities being offered in the Offering." 17 C.F.R. §240.15c212(b)(5)(i)(C). There is no apparent reason why an agreement to amend a term of a previously incurred financial obligation, if material, should not be equally reportable, even if it does not reflect financial difficulties.

What are “financial obligations”?

Financial obligations include debt obligations, certain related derivatives instruments, and guarantees of either.

Debt obligations. “Financial obligation” is defined to include a “debt obligation.” The Release interprets this term differently than its most common state law meaning. As interpreted in the Release, the term includes not only “debt” but also “debt-like” and “debt-related” obligations, including “leases that operate as vehicles to borrow money,” whether or not considered debt for state law purposes or a liability for accounting purposes.[18] As interpreted, the term includes both long-term and short-term obligations, including commercial paper and other short-term obligations whose offerings are exempt from the Rule.[19]

When is a lease a “vehicle to borrow money”? The Release cites two examples—lease-revenue transactions and certificates of participation transactions—in which a person advances money to an issuer with which to acquire or improve property, obtains title to or a lease of the property, and leases or subleases the property to the issuer in consideration for rent that repays the advance.[20] A lease from a pre-existing owner or vendor of property would not appear to be a “vehicle to borrow money,” even if relevant to the general financial condition of the issuer, because the issuer would receive only property, not money, in return for the rent. Would the result change if the owner/vendor were to discount the rent to a third party in a contemporaneous transaction known to (or discoverable by) the issuer? In any event, a lease-purchase agreement for personal property may be considered “debt,” and therefore a “debt obligation,” if treated as a secured financing under Section 2-102 of the Uniform Commercial Code, even if not a “vehicle for borrowed money.”[21] Consequently, it should be reported when it is incurred or its terms are amended, if material.

Derivative instruments. “Financial obligation” is defined to include “a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation.” The Release interprets “derivative instrument” to include “any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument,” but only if related to an existing or planned debt, either because entered into to hedge the debt or pledged as security for the debt.[22] For these purposes, a debt is “planned” if a reasonable person would consider it likely that the issuer will issue the hedged debt in the future, taking into account factors described in the Release, regardless of whether the issuer actually intends or believes that it will.[23]

In addition to interest rate swaps and forward contracts for the purchase and sale of municipal securities,[24] “derivative instrument” could include one or more of the following, if pledged to the payment of municipal securities, e.g., as part of a broad revenue pledge:

- a securities repurchase agreement in which proceeds of an issue of municipal securities are invested,
- a fuel hedge or similar forward contract,
- a take-or-pay contract for the supply of water or power, or
- a forward governments securities contract deposited into escrow to defease financial obligations.

Consequently, if an issuer incurs or amends any such contract, it would be required to give notice of that event, if material. If a forward bond purchase contract settles by the issuance of a debt obligation, then notice of both execution of the contract (the incurrence of a derivatives instrument) and its settlement (incurrence of a debt obligation) would be required, if material.

Guarantees. “Financial obligations” includes an issuer’s “guarantee” of a “debt obligation” or “derivative instrument” that is itself a “financial obligation.” For these purposes, “guarantee” is intended to include any contingent obligation to pay or secure a third party’s or the issuer’s financial obligations. The term includes a payment guaranty by a state or other governmental unit as well as the issuer’s undertaking to purchase its own demand securities if they are tendered and not remarketed.[25] Consequently, if an issuer makes a material guarantee of a financial obligation, and if the guarantee is not a municipal security (as would appear to be the case for a self-liquidity undertaking by a non-profit conduit borrower) or an official statement “consistent with” the Rule describing the guarantee was not filed with EMMA, the issuer would be required to give notice of the incurrence of a financial obligation.

18 Release, 83 Fed. Reg. at 44711.
19 Id. at 44710.
20 Id. at 44711.
21 Id. at 44712.
22 Id. at 44712–13.
23 Id. at 44713.
24 See SEC Rel. No. 33-9338 (July 18, 2012), which refers to an agreement for the purchase of a security at a fixed price and with forward delivery as a “forward contract.”
25 Release, 83 Fed. Reg at 44713–14.

The Release surprisingly states that an issuer should give notice of a third party's guarantee of a financial obligation of the issuer, if it constitutes a material term of the financial obligation.[26] The statement is surprising because it is difficult to imagine how a third-party guarantee would be a term of a separate obligation or would be either incurred or agreed to by the issuer, as required by paragraph (15) of the amendments to trigger a notice requirement.

Exclusion of certain municipal securities. The definition of "financial obligation" excludes municipal securities as to which a final official statement has been provided to the MSRB "consistent with" the Rule. The exclusion appears intended to exclude municipal securities only if (a) the underwriter or the issuer files a copy of the official statement with the MSRB (either in accordance with MSRB Rule G-32[27] or voluntarily) and (b) the official statement describes a CDA that satisfies the continuing disclosure requirements of the Rule, even if the offering is exempt from those requirements.[28] The exclusion should apply to securities that are exempt from the Rule requirement to obtain and provide an official statement on request, i.e., demand securities, short-term securities, and securities sold in a private placement or limited offering, and even to securities exempt from the Rule requirement to determine that a qualified CDA has been entered into, so long as a qualifying CDA is entered into and is described in an official statement filed with the MSRB. An issuer should check whether its underwriter has made the required official statement filing. If it has not, the municipal securities will be "financial obligations," and the issuer will be required to provide prompt notice of the issuance of the securities, unless the issuer causes the official statement to be filed.[29]

26 Id

27 Under MSRB Rule 32(b)(i)(B)(1), an underwriter of a primary offering of municipal securities must submit the official statement for the offering to EMMA within one business day after receipt and no later than the closing date, unless either (a) no official statement is prepared for the offering and the underwriter submits notice to that effect and the preliminary official statement, if any, (b) the offering is exempt from the Rule under paragraph (d)(1)(i) and the underwriter submits notice to that effect with contact information and delivers a copy of the official statement for the offering to customers on request, or (c) the offering is of commercial paper or a remarketing of demand securities exempt from the official statement requirements of the Rule and either no official statement is prepared for the offering or one was prepared and submitted in a prior primary offering of the securities and has not been supplemented or amended.

28 On first impression, (a) providing any official statement to the MSRB would appear to be "consistent with" the Rule (because the Rule does not restrict or otherwise address such a filing except to provide that, if made, the "end of the underwriting period" may be accelerated), and (b) providing an official statement without a CDA description would be "consistent with" the Rule when an offering is exempt from the Rule's continuing disclosure requirements. Nevertheless, the Release interprets "consistent with this rule" to mean in compliance with the continuing disclosure requirements of the Rule, applied as if the offering were not exempt from them. (The Release states that the SEC declined to revise the amendments to exempt obligations for which an official statement is provided to the MSRB voluntarily, as requested by some comment letters, unless the issuer "submit[s] the final official statement to the MSRB subject to the requirements of Rule 15c2-12(b)." Paragraph (b) of the Rule includes both the continuing disclosure requirements and the requirement for underwriters to obtain an official statement that describes the CDA and material breaches of CDAs in the prior 5 years.) Release, 83 Fed. Reg. at 44715.

29 Id.

The filing of a final official statement excludes municipal securities, but not other ancillary obligations, from being "financial obligations." Consequently, ancillary obligations that are also municipal securities, e.g., state guarantees or conduit obligations described in the definition of "municipal securities,"[30] would also be excluded from "financial obligations" if the obligor enters into a CDA, and an official statement describing the CDA and prior breaches has been filed with the MSRB. An official statement filing does not similarly exempt derivatives contracts, guarantees, or other financial obligations that are not municipal securities, even if they are entered into in a related contemporaneous transaction and are described in the official statement.[31] Consequently, an issuer would be obligated to provide timely notice of any such derivatives contract, guarantee, or other financial obligation, if material, including possibly the loan obligations of a conduit borrower in a non-profit education or healthcare financing or a multi-family housing financing.[32] Any such notice could merely refer to a filed official statement for a description of the financial obligation and its terms, if they are adequately described there.

Normal course exclusion. As interpreted by the Release, "financial obligations" also excludes "ordinary financial and operating liabilities incurred in the normal course of an issuer's or obligated person's business."[33] This exclusion will be helpful in excluding many pledged derivative instruments from reporting requirements, at least for recurring transactions associated with operations, and might also exclude lines of credit to accommodate seasonal cash flow deficiencies, rather than budget deficits or major construction and acquisition projects.

When is a financial obligation "incurred"?

Under the amendments, notice of a financial obligation must be given only when it is incurred. When is it "incurred" for these purposes?

Incurred generally. According to the Release, a financial obligation is "incurred" when it is enforceable against the issuer,[34] irrespective of whether it is subject to conditions

30 Securities Exchange Act of 1934, §3, 15 U.S.C. § 78c.

31 Release, 83 Fed. Reg. at 44715.

32 "Municipal securities" is defined to include underlying conduit borrower obligations supporting industrial development bonds that were tax-exempt under specified sections of the Internal Revenue Code of 1954, but such obligations did not include non-profit or multifamily housing financings, which rely upon other sources of exemption from registration for the conduit borrower's obligations. Securities Exchange Act of 1934, §3, 15 U.S.C. § 78c.

33 Release, 83 Fed. Reg. at 44709.

34 Id. at 44708; see also, id. at 44708 n. 90 (drawdown bonds) and n. 91 (derivative instruments).

under which it will be created or issued.[35] The purpose of notice at that time is to provide investors with information with which to evaluate the impact of the financial obligation on the issuer's creditworthiness.[36] Consequently:

- Mutually committed drawdown bonds, where the purchaser is obligated (even contingently) to make advances to the issuer from time to time and the issuer is obligated to request, accept, and repay them, are incurred when committed, not when advanced.
- An issuer's obligation to repay advances under a letter of credit or liquidity facility issued to provide for the payment or purchase of municipal securities is incurred when agreed to, not when advances are made.
- Bonds are incurred when issued, not when sold, because no bond contract is entered into until the bonds are issued. (If bonds are sold for forward delivery, i.e., delivery at a later date than under normal settlement practice, then notice of the bond purchase agreement should be given, since it would appear to be a forward contract and, therefore, a "derivative instrument" and, consequently, itself a "financial obligation," absent further guidance from the SEC.)
- Derivative instruments are incurred when enforceable against the issuer. An interest rate swap with a forward effective date would generally be incurred on the trade date, since it would then become enforceable against the issuer, rather than the later effective date.

Drawdown bonds/CP/lines of credit. Suppose an issuer enters into an agreement for drawdown bonds or a line of credit, agrees to repay advances with interest if made, but has an option (rather than an obligation) to draw? Similarly, suppose the issuer authorizes the issuance of commercial paper and issues an omnibus note, but reserves the right to create a balance under the note at its option? The Release states that notice should be given when the issuer "enters into an agreement providing for a material drawdown bond," rather than upon each material advance on the bond, but it fails to clarify whether the "agreement" is an agreement to draw or merely an agreement to repay a draw, if requested.[37] Since the SEC's drawdown bond guidance appears intended to ease administrative burden and inform investors of the potential for additional issuer liabilities, we believe notice may be given upon an agreement to repay advances, if made, or the execution of an omnibus CP note, rather than upon each advance or increase in a CP note balance. Additional guidance from the SEC would be helpful to reduce associated risk, however. Absent guidance, issuers may wish to provide notice of the agreement or CP omnibus note, if material when fully utilized, and an additional notice of each material draw or increase in the note balance. If each increase made at an issuer's option in amounts owed under a drawdown bond, line of credit, and/or CP note were to represent the "incurrence" of a financial obligation, then issuers would be obligated to provide notice of increases after first entering into a CDA that complies with the amendments, even if under an agreement entered into before the date of the CDA.

When is a term "agreed" to or "modified"?

The amendments also require an undertaking to provide notice of both (a) as stated in paragraph (15), an "agreement" to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation that affects security holders, if material, or (b) as stated in paragraph (16), a "modification" of the terms of a financial obligation reflecting financial difficulties. A modification could result from a waiver or other agreement not to enforce rights, even if oral.[38]

Although not addressed in the Release, paragraph (15) appears to require notice of any amendment to the terms of a financial obligation, if material, even if the amendment does not reflect financial difficulties. But must an issuer provide notice of a change in terms that results automatically from the issuer's initial agreement? Consider the following:

Remarketings. It is common for multimodal bonds placed with banks to reserve an issuer option to change the interest mode or the length of an interest period, if a remarketing agent remarkets the bonds and resets the interest rate. The bonds typically recite the issuer's intent not to extinguish or novate the original debt when the bonds are remarketed. Such a remarketing should not result in the incurrence of debt, even if treated as a constructive extinguishment and "reissuance" of an obligation for federal income tax purposes or a "primary offering" for purposes of the Rule. But does such a remarketing involve an "agreement" to modify the terms of the bonds, arrived at constructively by the issuer's offer and the new bondholders' acceptance of bonds with modified terms? Does the answer depend on whether the change results

35 Id. at 44708.
36 Id.
37 Id.

38 Id. at 44716.

from the application of a pre-agreed standard included in the municipal securities and disclosed to investors (e.g., resetting the interest rate to produce a par value) or rather is elected by the issuer? Or on whether the remarketing is a primary offering? If the remarketing is a primary offering and is treated as an "agreement" by the issuer to new terms, but the bonds are "financial obligations" because no official statement was filed with the MSRB when the bonds were issued, must the issuer provide separate notice of its agreement to the MSRB if the underwriter files an official statement for the remarketing with the MSRB "consistent with" the Rule? Consistent with the purpose of the Rule amendments, it would be good practice for an issuer to provide notice of the new terms, if material, even if they result from application of a previously disclosed standard. A CDA that complies with the Rule amendments could be interpreted to require that it do so.

Changes in spreads. When bonds or loans bear interest at an index (or a percentage of an index) plus a spread, it is common for the spread to be increased automatically by an agreed amount if the issuer's credit rating is reduced. Other financial obligations may provide for an automatic requirement to fund a debt service reserve or post collateral on certain conditions. When the obligations of an issuer (e.g., to pay interest, fund a reserve, or post collateral) change automatically under the terms of a financial obligation due to a rating downgrade or similar event, has there been a "modification of terms" or "other similar event" reflecting financial difficulties, thus requiring the issuer to provide notice of the change? Again, consistent with the purpose of the amendments, it would be good practice for an issuer to provide notice of the new terms, and its CDA could be interpreted to require that the issuer do so.

Elections when drawing. An issuer may have an option, when receiving an advance under a letter or line of credit, to elect the term over which the advance is repaid and whether interest on the advance will be fixed or reset at intervals. Assuming that notice of the execution of the facility is adequate notice of the incurrence of the financial obligations that result from future advances, must the issuer nevertheless give notice of each election of a term, if material?

When does an agreed term "affect security holders"?

Under a CDA that complies with the amendments, an issuer must provide prompt notice of the incurrence of a financial obligation. According to the Release, the notice must summarize or reproduce the material terms of the financial obligation.[39] (See "What must be included in a 'notice'?" below.) However, if an issuer later agrees to amend a term of the financial obligation, it must provide notice only if the amendment (a) reflects financial difficulties or (b) is material *and* "affect[s] security holders."[40] When does an amendment affect security holders?

Since the amendments require notice only if an agreement to terms *both* is material *and* affects security holders, at first blush something beyond merely affecting an issuer's credit is implied. However, the Release casts doubt on this conclusion. The Release cites two examples of terms that could affect security holders: (a) tax-related interest rate step-up provisions in a bank loan and (b) provisions in a derivative instrument to post collateral or make a termination payment upon certain conditions, each of which, the Release explains, could "impair an issuer's or obligated person's liquidity or creditworthiness."[41] The Release qualifies neither example as applying to financial obligations that are secured on a parity with, or otherwise peculiarly affect, the municipal securities that are the subject of the CDA. Accordingly, it is difficult to identify a difference between "affect security holders" and "material." Issuers and underwriters should treat the terms as synonymous, absent further guidance.

When is a financial obligation or term "material"?

Issuers must agree to provide notice of financial obligations and their terms only when they are "material." In addition, to comply with the Rule, underwriters must receive an official statement that describes each "material" breach of any prior CDA in the past 5 years. When is a financial obligation, term, or breach "material" for these purposes?

According to the Release, "material" has the same meaning as construed by the U.S. Supreme Court in applying the antifraud provisions of the federal securities laws: a fact is material if there is a substantial likelihood that a reasonable investor

39 Id. at 44707.
40 Id. at 44708.
41 Id. at 44710.

would consider the fact important[42] or the fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."[43]

In the Release, the SEC acknowledges that a "facts-and-circumstances" analysis is required, and that parties might reach different conclusions about materiality on the same facts.[44] The Release gives examples of terms that may be material: source of payment, security, priority of payment, principal or notional amount, maturity and amortization, interest rate, covenants, events of default, remedies, and "similar terms."[45] MSRB Notice 2015-03 suggests that the following information should also be included in public notice of bank loans and direct purchases: purpose, payment dates, optional and mandatory prepayment terms, ratings, governing law, tax status, CUSIP number, if any, redistribution rights, and financial reporting requirements.[46] Issuers should assume that terms suggested in the Release or the MSRB Notice are material, so should include them in notices of the incurrence of material financial obligations and should provide notice when they are modified materially.

Materiality determinations are susceptible to second guessing by the SEC. When it does so, the SEC is not constrained by the practice of actual investors. In its MCDC Initiative,[47] the SEC asserted extreme views of materiality in an apparent attempt to do indirectly what it is not legally authorized to do directly: compel issuer compliance with CDAs. For example, although disclosure of substantial breaches of prior CDAs has had no discernable impact on market acceptance or the pricing of investment grade municipal securities, in MCDC settlement orders the SEC found many undisclosed CDA breaches to be material, regardless of the issuer's financial condition or stability. In one order, it described the issuer's failure to comply with a prior undertaking in the fifth prior year to be a material omission for purposes of the antifraud provisions, even though the issuer did disclose that it had failed to comply in three of the last four years.[48] Similarly, in its MCDC settlement offers, the SEC gave no credit for information available on an issuer's website (or even located elsewhere on EMMA) in evaluating the "total mix" of available information. Because the SEC appears to approach "materiality" much like Justice Stewart approached pornography in *Portnoy's Complaint* ("I know it when I see it"),[49] issuers will be at risk whenever they fail to provide notice of a financial term or amendment because they believe it to be immaterial, and underwriters will be at risk if such failures are not disclosed in official statements as possible material CDA breaches.

According to the Release, whether "the incurrence of a financial obligation" in a series of related transactions is material should be judged by the cumulative effect of the transactions, unless the transactions are separated in time "for legitimate business purposes" rather than to avoid a disclosure obligation.[50] While "for" suggests subjective intent that would be known to issuers, the Release states that a facts and circumstances analysis should be made, suggesting an objective test that the SEC will be free to second guess. The Release does recognize that separating two issues of tax-exempt obligations in time in order to avoid an integrated issue for federal income tax purposes is a legitimate business purpose, implying that they would not be aggregated in evaluating their materiality.[51]

Since issuers must undertake to provide notice of the new events only "with respect to the securities being offered," materiality should be judged from the perspective of an investment in the issuers' municipal securities issued with the CDA. A particular financial obligation, if incurred, might be material to an investment in an issuer's airport revenue debt, yet not be material to an investment in its general obligation debt. An issuer would not be required to provide notice of the incurrence or material amendment of such a financial obligation if it has entered into a CDA for general obligation bonds on or after February 27, 2019, but has not yet entered into a CDA for airport revenue bonds on or after that date. Of course, it would serve good investor relations, and (after entering into a CDA that complies with the amendments) might be administratively less confusing, to provide notice of any financial obligation or modification that could be material to an investment in any of the issuer's outstanding public debt.

42 *Basic, Inc. v. Levinson*, 485 U.S. 224, 224 (1988).
43 *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).
44 Release, 83 Fed. Reg. at 44706.
45 Id. at 44705 and 44719.
46 MSRB Notice 2015-03 (January 29, 2015).
47 Municipalities Continuing Disclosure Cooperation Initiative, SEC Division of Enforcement, dated March 10, 2014, modified November 13, 2014.
48 In the Matter of the City of Andover, Kansas, Securities Act of 1933, Release No. 10139 (August 24, 2016). In the Release, the SEC attempts to distinguish the type of analysis undertaken in the MCDC analysis from the *TSC Industries* standard. The MCDC Initiative, according to the Release, "required an assessment of whether the issuer or obligated person materially fulfilled its contractual obligations under its continuing disclosure agreement, which required a consideration of applicable state law and basic principles of contract law." However, the charges brought against issuers and underwriters under the MCDC Initiative were for violations of the antifraud provision, rather than violations of the Rule. Consequently, in determining whether an issuer's failure to disclose prior CDA breaches was material, the TSC Industries standard of materiality must have been applied.
49 *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964).
50 Release, 83 Fed. Reg. at 44707.
51 Id.

When do events "reflect financial difficulties"?

Under an undertaking that complies with paragraph (16) as added by the amendments, an issuer will be required to provide notice of defaults, accelerations, terminations, modifications of terms, and other similar events with respect to a financial obligation only if they "reflect financial difficulties."[52] If they do, the events would be reportable even if the default may not become, or never becomes, an event of default that authorizes an acceleration or other remedies.

How substantial must financial reverses be before they amount to "financial difficulties"? The Release fails to define the term, which it asserts is not vague, but admits that additional guidance would be difficult to provide due to the diversity of issuers and financial conditions affecting them.[53] The Release begrudgingly acknowledges that a default in a covenant to give notice of a change in address "may" not reflect financial difficulties and, therefore, "likely" is not an event for which notice must be given. On the other hand, a failure to make a required deposit to a debt service reserve fund, the Release concludes, "likely" should be disclosed.[54]

Must financial reverses be material or result in actual difficulty before they arise to "financial difficulties"? Suppose, for example, a health care system amends its master indenture to reduce its required debt service coverage ratio from 120% to 110% following a year in which its actual ratio was 275%, down from a prior year ratio of 280%, with no foreseeable impact on its rating. Does the modification reflect "financial difficulties"? The answer should be no, but where is the line?

"Reflect" in common usage means "to make manifest or apparent." An event that results *from* financial difficulties would therefore be reportable. Would an event that merely *results* in financial difficulties be reportable? For example, suppose an issuer defaults in a performance covenant (e.g., a construction milestone) due to weather or other non-financial conditions, and the default results in a right to accelerate or take other action that adversely affects the issuer's financial condition or prospects, i.e., *causes* financial difficulties rather than reflecting pre-existing financial difficulties? The Release defends the amendments' use of "reflect financial difficulties" by stating that it helps "target the disclosures to result in information relevant to investors in making an assessment of the current financial condition of the issuer."[55] Events that result in financial difficulties would be as relevant to investors as events that are caused by them. Given the purpose of the amendments, issuers and underwriters should assume that an event that results in financial difficulties is also reportable, absent further guidance from the SEC to the contrary.

If investors tender demand securities for purchase due to concerns about an issuer's creditworthiness, are the puts reportable "accelerations"? Given the purpose of the amendments, issuers and broker-dealers might act as if they are, at least if the securities are not promptly remarketed and the issuer knows (or should know) why the investors tendered. Consequently, if an issuer's demand securities are not supported by bank obligations, they are put following issuer financial reverses, and the issuer's remarketing agents are required to mark up the interest rate on the securities materially to remarket them (or the securities can't be readily remarketed), issuers should consider treating tenders of the securities as if they were an acceleration reflecting financial difficulties, absent further guidance.

A termination event under a derivative instrument (e,g., due to a rating downgrade below a specified floor) is likely a "similar event," even if not characterized as a default, if the other party to the instrument could designate early termination, even though it has not done so. Would a decision not to appropriate for debt service on a subject-to-appropriation debt obligation be a "similar event," even though not a default?

An event under the terms of a financial obligation that reflects financial difficulties is reportable under a CDA that complies with the amendments, even if the financial obligation was incurred before the CDA was signed or even before February 27, 2019.

Modifications of publicly offered municipal securities.

If municipal securities are not "financial obligations" because an underwriter filed an official statement with the MSRB "consistent with" the Rule in the initial public offering of the securities, the issuer would not be obligated to provide notice of its agreement to modify the terms of the securities, if material, or of defaults or similar events with respect to the securities that reflect financial difficulties, as one of the two new events.

52 The SEC chose to use wording that describes other events included in the Rule before the amendments—unscheduled draws on debt service reserves or credit enhancement—where financial difficulties are not much in doubt. See 17 C.F.R. §§240.15c2-12(b)(5)(i)(C)(3), (4).

53 Release, 83 Fed. Reg. at 44716.

54 Id. at n. 187.

55 Id. at 44716.

If municipal securities are not “financial obligations” for that reason, the issuer nevertheless would be obligated to provide notice of a modification to rights of security holders, if material, a payment or other material default, or an unscheduled draw on debt service reserves that reflects financial difficulties, if material, under the terms of its CDA complying with the pre-amendment provisions of the Rule.[56]

Consequently, the Rule, as amended, will effectively require similar, but not completely symmetric, reporting requirements for events with respect to municipal securities and financial obligations.

What must be included in a “notice”?

According to the Release, a notice may not merely state that a material financial obligation has been incurred or that a material term has been modified. Rather, the notice “generally should include a description of the material terms of the financial obligation,” which it states may include the date of incurrence, principal amount, maturity and amortization, interest rate or method of computation (including default rates), among other possible terms.[57] The Release also states (without apparent support in the Rule text) that a third-party guarantee of a financial obligation is a term of the financial obligation, so the guarantee should be described in a notice of the financial obligation and be the subject of notice of a change in the guarantee, if material.[58]

According to the Release, a notice may summarize the material terms of a financial obligation or (as an alternative or in addition) file a term sheet for or a redacted version of the financial obligation agreement, “depending on the facts and circumstances.”[59] The Release does not indicate what facts and circumstances, if any, might require a summary to be filed in lieu of a term sheet or redacted version of the financial obligation agreement or vice versa. If a redacted version is filed, contact information, account numbers, and other personal identifying information may be redacted, but not a material term.[60]

Registered companies may redact confidential information from agreements filed with the SEC as exhibits to Form 8-K, if they make and the SEC approves a confidential treatment request. The SEC may permit a company to redact information (e.g., pricing terms, technical specifications, and milestone payments) from Form 8-K exhibits if disclosure of the information could adversely affect the company’s business and financial condition.[61] May a registered company acting as a conduit borrower reserve in its CDA the right to redact or otherwise withhold possibly material information from a notice if and when the SEC permits the information to be redacted from an exhibit to the company’s current report of the event on Form 8-K?

What should issuers do to prepare?

To retain access to the public debt markets after the amendments begin to apply, issuers should (a) enter into CDAs that comply with the amendments, (b) revise or adopt continuing disclosure procedures that will enable them to comply with (and underwriters to rely on) the new CDAs, and (c) track and, in subsequent offerings, fairly disclose material breaches of the new CDA provisions. Doing so will make underwriter diligence in future offerings more efficient and will enable issuers to avoid the reputational and financial expense associated with SEC enforcement actions.

Continuing disclosure agreements. Issuers should, of course, add the two new event paragraphs and the definition of “financial obligation” to CDAs entered into on after February 27, 2019. However, the Release interprets the amendments inconsistently with (or at least not readily apparent from) the plain meaning of the amendment paragraphs. In some cases it does so to narrow the scope of the amendments. Issuers should consider qualifying their CDAs to benefit from the clarity added by the Release, e.g., by adding language substantially as follows: “The [issuer] intends the words used in paragraphs (15) and (16) and the definition of ‘financial obligation’ to have the meanings ascribed to them in SEC Release No. 34-83885 (August 20, 2018).”

Continuing disclosure procedures. Issuers should amend or adopt continuing disclosure procedures before selling municipal securities in an offering that is not exempt from the continuing disclosure provisions of the Rule and for which a CDA is entered into on or after February 27, 2019. Issuers with more complex or diffuse financial operations should begin doing so well in advance of an offering for which an updated CDA will be required to comply with the amendments. To do

56 17 C.F.R. §240.15c2-12(b)(5)(i)(C)(7).
57 Release, 83 Fed. Reg. at 44708; see, also, MSRB Notice 2015-03 and accompanying text at note 46 supra.
58 Id. at n. 159.
59 Id. at 44708.
60 Id.

61 Section II.A, Staff Legal Bulletin No. 1, dated February 28, 1997, as amended by the Addendum, dated July 11, 2001, issued by the staff of the SEC’s Division of Corporation Finance.

so, depending on the extent, complexity, and diffuseness of their financial operations, they could:

- become familiar with the new types of events that they must report promptly,
- develop understandable descriptions of the new types of events as well as quantitative and qualitative criteria for identifying which may be material,
- identify which departments are likely first to have knowledge of potentially reportable event of each type (e.g., incurring or amending the terms of a material forward contract, breaching a covenant, etc.),
- provide the descriptions and criteria to those departments and require them (initially and with periodic reminders) to report any such event to the finance or other department responsible for continuing disclosure,
- develop procedures and assign responsibility for evaluating such events for materiality or financial difficulties, as applicable (and for recording why an event was not considered material or to reflect financial difficulties, if not reported),
- develop guidelines for when and how to summarize any such event or file redacted documents and to review and authorize filings,
- incorporate the updated procedures into periodic training of affected personnel, and
- confirm compliance with underwriters' official statement filing requirement under MSRB Rule G-32 in each public offering.

Issuers benefit from written disclosure policies and procedures. If the procedures are followed, they make an actionable misstatement or misleading omission of a material fact less likely. They also reduce the chance that any such misstatement or omission, if it does occur, would be considered to result from knowing, reckless, or negligent conduct, which are prerequisites for legal recourse against the issuer. For this reason, the Government Finance Officers Association (GFOA) has recommended that issuers adopt written disclosure policies and procedures have been recommended. For considerations in preparing disclosure policies and procedures, see *Crafting Disclosure Policies*, published by the National Association of Bond Lawyers (NABL) in 2015.[62]

The extent, complexity, and diffuseness of an issuer's financial operations will affect the types of additional disclosure procedures that it should adopt. If, in the case of a small, limited purpose issuer, no financial obligation may be incurred or modified without the knowledge of the issuer's chief financial officer, then the issuer might simply add to its written description of the CFO's duties a duty to give prompt notice of any event of the two new types. For larger issuers with more complex and/or diffuse financial operations, most or all of the above steps should be considered.

To distinguish reportable events, an issuer could develop criteria for the types of financial obligations and terms that might be material, the minimum amount of financial obligations of different types that could be material (depending on their terms, e.g., are they subject to acceleration, collateral posting, etc.), and the types of defaults and similar events that might reflect or result in financial difficulties. The criteria could identify financial obligations and terms that are clearly not material, those that clearly are, and those that are in-between (and or which the issuer might seek outside guidance).

Some commentators have suggested that issuers will be unlikely to be able to comply with a CDA entered into on or after February 27, 2019, unless they first develop a list of all outstanding financial obligations and their terms. We disagree. Even after entering into a CDA that complies with the amendments, an issuer will not be required to give notice of any of the new events with respect to a financial obligation that is outstanding on the date of the CDA unless the issuer agrees to a material amendment of the obligation or experiences financial difficulties. For most issuers, its chief financial officer should be aware of any amendment to a material financial obligation and any event under a financial obligation that would reflect or result in financial difficulties. If an issuer is able to monitor for any such amendment or event, it should be able to comply with its post-amendment CDAs without first developing a list of financial obligations or their terms.

Many market participants (including nearly all underwriters) are operating under cease and desist orders imposed in the MCDC initiative. They, understandably, may be reluctant to

62 National Association of Bond Lawyers, "Crafting Disclosure Policies," available at https://www.nabl.org/DesktopModules/Bring2mind/DMX/Download.aspx?PortalId=0&TabId=176&EntryId=1008.

conclude that issuer failures to provide notice of financial obligations, amendments, defaults, and similar events are not material breaches, and therefore do not need to be disclosed in official statements, unless that conclusion is clear. Accordingly, issuers should both (a) provide notice of any financial obligation (or amendment of its terms) that might be material, as well as any default, modification, or similar event that might reflect financial difficulties, and (b) be prepared to disclose any failure to do so in their subsequent offering documents.

Coordination with other disclosure. Issuers prepare official statements for public offerings of their municipal securities, and they file annual financial information (generally including audited financial statements) with EMMA. Issuers may not omit any material fact from their official statements and annual financial information if, as a result, they are rendered misleading.[63] In determining whether a financial obligation or its terms are material, an issuer should apply consistent standards and make consistent judgments, both when preparing an official statement or annual financial information and when deciding whether to give notice of a financial obligation, amendment, or other modification under a CDA.

Under Governmental Accounting Standards Board (GASB) Statement No. 88, applicable to fiscal years ending after May 31, 2019, issuers who report their financial position in accordance with generally accepted accounting principles for governmental entities (GAAP) will need to include (in financial statements notes) summarized information about significant events of default or termination events with finance-related consequences, as well as significant subjective acceleration clauses, if included in the issuer's debt. "Debt," for these purposes, does not include leases (unless accounted for as a financed purchase) or forward or other derivatives contracts, and the summarized information need not include maturity dates, interest rates, or other information that the Release suggests might be material.[64] Consequently, summaries of debt obligations that merely comply with GAAP note requirements may not provide adequate notice of the incurrence of the debt obligations under a CDA that complies with the amendments.

Method of providing notice. In determining whether to provide summaries, term sheets, or redacted documents when giving notice of financial obligations and their terms, issuers should take into account possible risks, expenses, and impacts on investor relations.

Summaries require more time and cost to produce, and they subject issuers to potential claims that material terms were misstated or omitted. Issuers should, in any event, summarize the same material terms of the same financial obligations when they next access the public debt markets, but they may have more time or better access to external advice when they do so. Issuers could consider disclosing their financial obligations by (a) expanding the content of GAAP-required financial statement notes to summarize all terms of financial obligations that could be material to security holders, (b) developing a template for such disclosure, and (c) using the template both to provide prompt notice of the incurrence of material financial obligations (and material modifications of their terms) and to prepare summaries to be included in financial statement notes. If issuers choose this alternative for notices, they should establish a standard for identifying potentially material terms. Consider, for example, a bank loan agreement that includes 15 separate events of default, one of which is a failure to cure a breach of any of 45 covenants in the agreement after notice from the bank. Must each covenant and event of default be summarized? We believe, in general, an issuer may reasonably choose to summarize only covenants to take or refrain from action that both is not within its control (e.g., to maintain a minimum rating or EBITDA coverage of debt service as opposed to making periodic reports or not to grant a lien) *and* could result in acceleration, a collateral call, or a similar event that could affect the issuer's liquid assets available to pay or otherwise materially impact the credit for its affected municipal securities.

Alternatively, in giving notice of a new financial obligation, an issuer could file or link to a redacted version of the financial obligation agreement. Redacted agreements are generally easier to produce and pose less risk, but may be less investor friendly and merely defer, rather than avoid, the need to summarize material terms in the issuer's next public offering. Redacted agreements may be less investor-friendly if they are very technical or long, since they will require a greater investment of time to identify material terms. On the other hand, notices made by filing redacted documents should be easier for underwriters sand their consultants to check, since checking the completeness of a summary of terms would likely involve much more work than checking for impermissible redactions. If issuers choose to give notice by filing redacted documents, they should establish a standard for identifying immaterial terms that may be redacted.

63 Securities Act of 1933, §17, 15 U.S.C. §77q(a); Securities Exchange Act of 1934, §10(b), 15 U.S.C. §78j; Rule 10b-5, 17 C.F.R. §240.10b-5.
64 Statement No. 88 of the Governmental Accounting Standards Board: Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements (March 2018), available at https://www.gasb.org/jsp/GASB/Document_C/DocumentPage?cid=1176170308047&acceptedDisclaimer=true.

In deciding whether to summarize or file a redacted copy of a financial obligation agreement, issuers should monitor developments and consult their municipal advisors (or, in an offering, their underwriters) for advice on whether filing formats could affect investor relations (and therefore future access to the capital markets). Whether issuers summarize or file a redacted version of a financial obligation agreement, they will need to determine whether they may redact or otherwise exclude (as immaterial) commitment fees, spreads to index rates, and similar terms that a bank may wish to withhold from its competition and/or other customers.[65] Issuers that determine to include such terms should seek permission to do so in any confidentiality agreement with the bank. In any event, as with all event notice filings, issuers should disclaim any implication that the notice contains all information material to an investment in the issuer's securities, especially if pre-existing non-public financial obligations are not disclosed when filing notice of a new financial obligation.

What should underwriters and other broker-dealers do to prepare?

Compliance of CDAs. When participating in a primary offering of municipal securities that is subject to the continuing disclosure provisions of the Rule and for which a CDA will be entered into on or after February 27, 2019, underwriters must confirm that the CDA complies with the Rule, as amended. According to the SEC, an underwriter must "evaluate carefully the likelihood that the issuer or obligated person will comply on a timely basis with the undertakings it has made."[66] Consequently, in participating in such an offering, an underwriter should confirm that the issuer construes the additions to its CDA consistently with the Release and has adopted or adjusted its compliance procedures so as to be likely to comply with the added paragraphs of the CDA.

When the continuing disclosure provisions of the Rule were first adopted, the SEC staff advised that CDAs must undertake to give notice of each event listed in the Rule "in the same language as is contained in the rule, without any qualifying words or phrases," even if one or more events is inapplicable to the securities being offered.[67] The Release interprets the amendments inconsistently with (or at least not readily apparent from) their plain meaning. In some cases, the interpretations expand the scope of the amendments. Given that fact, what must an underwriter do to confirm that the issuer has entered into a CDA that satisfies the requirements of the Rule, as amended? An underwriter could confirm issuer intent by accepting a CDA with the qualification suggested above. (See "What should issuers do to prepare—Continuing disclosure agreements.") The SEC could not reasonably object to such a qualification. Absent such a qualification, underwriters could (a) provide (or confirm that the issuer has otherwise received) an adequate summary of the amendments as interpreted by the Release and (b) confirm with the issuer that the CDA should be interpreted accordingly. In any event, underwriters should modify their own compliance policies and procedures to provide how they will confirm the likelihood of an issuer's compliance with the new provisions of CDAs.

Compliance with expanded CDAs. When participating in primary offerings of municipal securities that are not exempt from the Rule, underwriters must obtain, review, and distribute a "final official statement," which must include a description of each material breach of the obligated person's prior CDAs in the past 5 years.[68] According to the SEC, when participating in an offering of municipal securities, underwriters should inquire into whether the issuer has disclosed all such breaches in the official statement. If the underwriter fails to inquire into the issuer's compliance history, or finds that the issuer has failed to provide required event notices (or annual reports) on multiple occasions in the prior 5 years or has failed to cure breaches, then "it would be very difficult" for the underwriter to determine that an adequate CDA is being entered into for the offering.[69] According to the SEC, in making such a determination an underwriter may rely on issuer policies and procedures that are "reasonably designed" to comply with a CDA event filing undertaking, if the issuer regularly reviews the procedures' effectiveness and promptly addresses deficiencies.[70] In addition, in negotiated offerings, to determine whether unreported reportable events have occurred, the SEC has stated that an underwriter may question the issuer, obtain a factual certification (that is not qualified for materiality) from it, and independently evaluate whether the unreported certified events are material.[71] In competitive offerings, the SEC has stated that an underwriter may compare official statement

65 Permitted redactions from liquidity documents submitted to the MSRB's SHORT system under MSRB Rule G-34(c)(ii)(B) may be, but are not necessarily, instructive. (Not necessarily, since they reflect MSRB interpretations of or exemptions from a rule that requires remarketing agents to submit the "current versions" of liquidity support documents, rather than merely their material terms.) The MSRB permits commitment fees to be redacted from liquidity documents (as well as redactions to maintain internal security or the confidentiality of personal information), but not "information that is critical to investors and other market participants, such as the interest rate accruing on bank bonds." MSRB Notice 2012-20 (April 11, 2012).

66 SEC Release No. 62184A, 75 Fed. Reg. 33100, 33123 (June 10, 2010).

67 Letter from Catherine McGuire to National Association of Bond Lawyers, Response to Question 2 (Sept. 19, 1995).

68 17 C.F.R. §§240.15c2-12(b)(1)-(4), (f)(3).

69 SEC Release No. 62184A, 75 Fed. Reg. 33100, 33124 (June 10, 2010).

70 Id. at n. 351.

71 Id. at 33124–25.

disclosure about CDA compliance history with information available to it.[72] That information may include loans made, securities purchased, and amendments and waivers of financial obligations agreed to by the underwriter (or perhaps its affiliates) in non-public transactions.

To comply with their duties in underwriting primary offerings by an issuer after it has entered into a CDA that complies with the amendments, underwriters could consider (a) developing an updated due diligence checklist, (b) requesting additional certifications in bond purchase agreements (or a separate certificate), and (c) hiring counsel or a consultant as part of the overall due diligence process.

For offerings with a CDA containing the new amendments for the first time, an underwriter's checklist could address the following:

- Does the issuer have updated policies and procedures reflecting the new amendments?
- Does a review of the policies and procedures reflect, or does the issuer otherwise have, an understanding of the new notice requirements, as construed by the Release?
- Has the issuer established criteria to determine whether a financial obligation or modified term is material or when it has incurred financial difficulties? If so, are the criteria reasonable? If not, how will the issuer make that determination?
- Who are the issuer staff members responsible for determining the occurrence of a reportable event? What is the process by which they will obtain knowledge of an event? Will the process enable them to prepare and file a timely notice with EMMA?

For subsequent offerings, an underwriter's checklist could also address the following (or provide for engagement of counsel or another service provider to do so):

- Ask for and review a list of financial obligations incurred or amended in the prior 5 years that were (or the amendment of which was) material according to the issuer's compliance policies, if objective and reasonable (or, for issuers without such policies, according to the underwriter's criteria for financial obligations and terms that might be material), along with the dates on which the obligations were incurred or amendments agreed to.
- Verify that official statements for municipal securities issued in the prior 5 years were timely posted to EMMA and included disclosure of a CDA that satisfied the Rule, even if the offering was exempt.
- Ask for and review a list of each default, event of acceleration, termination event, modification or other waiver, or other similar event under the terms of a financial obligation that occurred due to weakened credit, a rating downgrade, or an inability (or perceived inability) to comply with financial covenants.
- Check EMMA to determine whether the issuer provided notice of each such incurrence, amendment, or other event (including each issuance of municipal securities, unless an official statement was timely posted to EMMA) within 10 business days after it occurred, and, if summaries were filed, whether they described each material term.
- If any such notice was not filed timely or was incomplete, determine independently whether the filing failure, if a possible breach of the CDA, could be material and, if so, whether the filing failure is disclosed in the official statement.
- Document the process and the underwriter's basis for deciding that a failure to file was not a breach or not material.

Of course, if this exercise reveals the existence of a previously undisclosed material financial obligation, the underwriter should assure that notice of the financial obligation is provided to EMMA to cure the possible CDA breach and that a summary of the material terms of the financial obligation is added to the official statement, e.g., by appending financial statements that summarize the material terms. Checking for the existence of an undisclosed material financial obligation or term is prudent due diligence for any offering. What is new for offerings after an amendments-compliant CDA has been entered into is determining whether the issuer gave timely notice of the incurrence or amendment of a material financial obligation, whether or not disclosed in the official statement, promptly after it was incurred or agreed to.

72 SEC Release No. 34-26100 (September 22, 1988), 53 Fed. Reg. 37778, 37790.

Secondary market procedures. Broker-dealers should update their procedures to comply with their duties under the Rule and MSRB rules after February 27, 2019.

To comply with Rule 15c2-12(c),[73] broker-dealers should verify or update their procedures to assure that they will receive prompt notice of all event notices filed on EMMA, including pursuant to one of the two new paragraphs of the Rule, before recommending transactions in municipal securities to a customer.[74]

In determining whether a recommended transaction or municipal security is suitable for a customer, to comply with MSRB Rule G-19 broker-dealers must use "reasonable diligence" to "understand the material information regarding the municipal security."[75] In addition, to comply with MSRB Rule G-47 a broker-dealer may not trade in a municipal security with a customer without disclosing, at or prior to the time of trade, material information about the security that is reasonably accessible to the market. Event filings are readily accessible and should be presumed to be material, until they are reviewed. Broker-dealers should determine how to sift through, analyze, and inform customers of the potentially voluminous financial obligation documents that may be filed with EMMA before engaging in transactions in securities of an issuer that has entered into a CDA on or after February 27, 2019. Except for transactions with a sophisticated municipal market professional,[76] the MSRB has stated that broker-dealers may not satisfy their disclosure obligations under Rule G-47 merely by referring a customer to EMMA filings.[77] Since the SEC has permitted issuers to provide notice of financial obligations by filing redacted copies on EMMA, the MSRB should modify its guidance to enable broker-dealers to comply with Rule G-47 by sending customers a link to the issuer's continuing disclosure page on EMMA.

What should municipal advisors do to prepare?

In its release proposing the Rule as initially adopted, the SEC asserted that, when a financial advisor participates in a competitive offering, it has duties to inquire into the accuracy and completeness of disclosure that are "comparable" to the duties of underwriters in negotiated offerings, when the financial advisor also has access to issuer information, participates in drafting the official statement, and publicly associates itself with the offering, e.g., by disclosing its role in the official statement.[78] Before participating in a competitive offering of municipal securities that is subject to the continuing disclosure provisions of the Rule and for which a CDA will be entered into on or after February 27, 2019, municipal advisors should consider revising their policies and procedures as recommended above for underwriters participating in negotiated offerings.

Municipal advisors could also recommend that issuers engage underwriters counsel in advance of the offering to represent the successful bidder (as was once the practice in competitively bid securities issued by public utility holding companies), and that they address their 10b-5 negative assurance letters to both the underwriter and the municipal advisor. Unlike disclosure counsel engaged by an issuer, which (absent agreement to the contrary) has no duty to investigate issuer records, underwriters counsel would have a duty to assist in making a professional review of the official statement for accuracy and completeness, and thus could be relied upon by municipal advisors in complying with their own duties, in the eyes of the SEC, to check information supplied by the issuer or others.

Cost/benefit and legality

In adopting the amendments, the SEC updated its cost benefit analysis, including for purposes of the Paperwork Reduction Act. In response to comment letters, the SEC increased its estimate of annual dealer costs five-fold and of annual issuer costs two-fold, despite slightly less onerous final amendments. Corrections of this magnitude suggest that the SEC employed a wholly inadequate cost estimating process in proposing the amendments. Based on a survey of its members, NABL concluded that the SEC's estimates for the proposed amendments were off by a factor of 134x for issuers and 287x for broker-dealers. Consequently, there is reason to believe that the SEC again has refused to acknowledge the real costs of the amendments.

In updating its economic analysis, the SEC predicted that qualitative benefits would result from the amendments (essentially, improved market transparency and resulting pricing benefits), but also again acknowledged that it could not

73 17 C.F.R. §240.15c2-12(c).
74 According to the Release, procedures to receive notice of any of the new events is required only before recommending transactions in municipal securities with CDAs entered into on or after February 27, 2019, but given MSRB rules (described in the next paragraph), that distinction is a trap for the unwary. Release, 83 Fed. Reg. at 44718.
75 MSRB, "2016 Compliance Advisory for Brokers, Dealers and Municipal Securities Dealers" at page 5, available at http://www.msrb.org/msrb1/pdfs/Dealer-2016-Compliance-Advisory.pdf.
76 "Sophisticated Municipal Market Professional" or "SMMP" as described in MSRB Rule G-48.
77 See Supplementary Material to MSRB Rule G-47; see also MSRB Rule G-48.
78 SEC Release No. 34-26100, 53 Fed. Reg. at 37781, 37790 n. 92.

quantify the benefits. Nevertheless, the SEC somehow weighed the unknown quantity of benefit against its underestimated quantification of costs, and apparently (although not expressly) concluded that the amendments passed a cost-benefit analysis. The SEC also concluded that the amendments are "reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices in the municipal securities markets," satisfying a condition to its legal authority to adopt the amendments.[79]

In concluding that the amendments are reasonably designed to prevent fraud, the SEC apparently concluded that investors would become better informed about an issuer's credit, so would be less likely to be defrauded in a transaction with another party armed with a material fact not disclosed to the investor. That result presupposes that investors are equally likely to be able to review and analyze voluminous technical financial documents in which the additional material facts are disclosed. If an institutional investor does so and a retail investor does not, then asymmetric knowledge among transaction participants will persist. In fact, it may well become worse. When both buyers and sellers are equally uninformed, due to inadequate publicly available information, they trade in the secondary market with symmetric access to material facts. After the amendments are implemented, institutional investors will have the means to become better informed than retail investors who do not have the time, patience, or ability to review filed financial documents and play "Where's Waldo." This possible unintended consequence of the amendments could be asserted to challenge the SEC's authority to adopt them.[80] If the amendments are not reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, the SEC has no legal authority to adopt them, even if they improve the municipal securities markets by increasing transparency.

79 Release, 83 Fed. Reg. at 44703.

80 *See Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) (Securities Exchange Act and Administrative Procedure Act impose a "statutory obligation to determine as best it can the economic implications of [a] rule."); *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (Commission failed "adequately to assess the economic effects of a new rule").

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