Commentary How SEC's Rule 15c2-12 changes create challenges for municipal market

By **Stanley Keller**
Published **October 15 2018, 10:18am EDT**

More in **Municipal disclosure**, **MCDC**, **SEC enforcement**

The SEC's March 2017 proposal to expand continuing disclosure required by municipal issuers and obligated persons drew sharp criticism from participants in the municipal securities industry, some justified and some not. To its credit, the SEC significantly revised its proposal to address some of the concerns when it recently adopted the amendments to Rule 15c2-12 to add two new events required to be currently reported — (i) incurrence of a material financial obligation, including a debt obligation, and material terms of a financial obligation and (ii) a default or other event under a financial obligation reflecting financial difficulty. Unfortunately, the amendments as adopted still create problems for municipal market participants.

To be clear, I am not talking about complaints about leaving the term "material" undefined — municipal market participants have to deal with that term now and "materiality" is a concept that pervades federal securities law, requiring exercise of reasonable judgment. Nor am I talking about complaints over the meaning of "financial difficulty" — that term is already a limitation in Rule 15c2-12 and similarly requires exercise of reasonable judgment. Instead, I am talking about the Commission's decision to focus on information useful to investors without adequately recognizing the need to ensure that municipal issuers and obligated persons are able to readily comply with the new requirements. The need to balance these considerations has been consistently recognized in the SEC's rules governing public reporting company disclosure requirements, as illustrated by the formulation of Item 2.04 of Form 8-K dealing with certain financial obligation triggering events.

Stanley Keller, Locke Lord LLP

The absence of this balance is reflected in the approach to defining "debt obligations" in at least two respects. First, although the SEC acknowledges the adoption of GASB Statement No. 88 requiring expanded disclosure related to debt in audited financial statements as a positive development, it does not relate use of this new accounting standard to compliance with the additions to Rule 15c2-12 or mesh the compliance date for the Rule 15c2-12 amendments with the availability of financial statements applying the new accounting standard. Second, is the inclusion through guidance of leases that operate as "vehicles for borrowing money," which is a new concept untethered from historic accounting rules that have distinguished between "capital leases" and "operating leases." Although this distinction is being eliminated by changes in the accounting for leases, the guidance in the adopting release leaves unclear whether the concept of capital leases has any continuing relevance in the analysis of which leases might be considered to be debt obligations.

The absence of this balance also is reflected in the formulation of the events reflecting financial difficulty added to Rule 15c2-12. Rather than using the more certain formulation of Item 2.04 of Form 8-K applicable to reporting by corporate issuers that is triggered by an "event of default," which typically requires notice to be given, the Commission used the broader and more elusive requirement to report "defaults" and certain other events reflecting financial difficulty. These events can exist without a reporting person even knowing of them. As a result, municipal issuers and obligated persons, ironically, are subject with respect to these event matters to more extensive continuing reporting obligations than corporate issuers subject to the SEC's current reporting rules.

The SEC's failure to adequately take into account the feasibility of compliance is likely to create significant problems for municipal market participants, especially following the industry's experience with the SEC's Municipal Continuing Disclosure Cooperation Initiative. Reporting persons are required to disclose in the official statement for a municipal securities offering subject to Rule 15c2-12 any failure to comply in all material respects with a continuing disclosure agreement that occurred within the prior five years and municipal underwriters are required to take reasonable steps to determine whether the reporting person has complied. This led to extensive diligence and cautious positions taken by some underwriters arising from the MCDC Initiative. The lack of precision in the new Rule 15c2-12 event requirements and the possibility of events having occurred of which the reporting person is unaware or may not consider to have been triggered is likely to make the diligence underwriters will undertake

more burdensome and increase the disagreements between underwriters and reporting persons over compliance with disclosure requirements. Hopefully, sensible guidance from the SEC will help ameliorate some of these difficulties.

Stanley Keller