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The New SEC Disclosure Rule 15c-12: Questions and Answers

To assist issuers who are in the process of determining what impact, if any, the changes to Securities and Exchange Commission (SEC) Rule 15c2-12 concerning primary and secondary market disclosure will have on their disclosure practices, the GFOA Federal Liaison Center has developed the following questions and answers concerning the rule's implementation. For a fuller understanding of the "Final Rule," which was approved by the SEC on November 10, 1994, and its impact, GFOA members are urged to consult with their financial advisor or bond counsel. Issuers should also refer to the SEC's "Adopting Release" (Release No. 34-34961), which explains the rule changes, and the GFOA *Washington Update* on the "New SEC Municipal Securities Disclosure Rule," dated December 9, 1994, which offers a general description of the rule.

The new provisions of Rule 15c2-12 were adopted by the SEC under the antifraud provisions of the federal securities laws, which apply to issuers and other market participants, to prevent the underwriting and recommendation of municipal securities about which little or no information is provided on an ongoing basis. Technically, the rule addresses underwriter requirements and responsibilities in the offering of municipal securities and does not directly regulate municipal securities issuers. However, since the offering of securities by an underwriter is conditioned upon the existence of a binding commitment by the issuer or other parties to provide annual financial information and material events disclosure, issuers should review their disclosure practices so that appropriate disclosure is available on a timely basis.

To complement this effort, the SEC used its interpretive authority and issued Interpretive Release No. 33-7049 and 34-33741 on March 9, 1994, which provides the SEC's views regarding disclosure by municipal market participants in meeting their responsibilities under the antifraud provisions of the federal securities laws. The antifraud provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 generally prohibit fraudulent and deceptive practices in the offer, purchase and sale of municipal securities. Any person, including municipal issuers, brokers and dealers, who makes any false or misleading statement of material fact or omits any material facts that cause such statements to be misleading in the context in which the statements are made, violates the federal law. The commission has previously warned issuers that any information reasonably expected to reach investors, even if it does not take the normal form of a disclosure document and is not directed specifically at market participants, may be viewed as a statement subject to the antifraud provisions. Information may include documents, public statements and press releases. Penalties for violations of the federal securities laws and rules promulgated thereunder include cease and desist orders, injunctions, monetary damages, and fines and imprisonment, or both.

The Interpretive Release, which should be reviewed by all market participants, deals with broad concerns such as

- ways to improve official statement disclosure, including disclosures about political contributions and derivatives;
- mechanisms for issuers to use to provide ongoing disclosures about outstanding debt to investors to avoid violations of the antifraud rules; and
- broker/dealers' responsibilities for reviewing issuers' disclosure documents and other information about issuers and their issues before recommending securities to investors.

Since the Interpretive Release provides the SEC's interpretation of existing law, in effect, it provides guidance about disclosure responsibilities pertaining to all debt—both outstanding and newly issued debt. Issuers therefore are encouraged to review their disclosure practices generally and not just those for new issues.

The SEC strongly recommends that issuers consult the GFOA's *Disclosure Guidelines for State and Local Government Securities* and other guidance, such as the National Federation of Municipal Analysts' (NFMA) *Disclosure Handbook for Municipal Securities*, which contains recommendations about the type of information that is needed on a sector-by-sector basis to evaluate specific credit risks in the primary and secondary markets.

The following questions and answers are intended to help issuers understand the new rule and the Interpretive Release and their impact on state and local governments. Issuers are cautioned that there will be many unanswered questions as the new disclosure system evolves, but they should be assured that GFOA is working with other market participants and the SEC to facilitate the implementation process.

What are the requirements of the rule that affect issuers?

In general, the rule prohibits dealers from underwriting municipal securities of $1.0 million or more unless the issuer or an obligated person has undertaken in a written agreement (an "undertaking") or contract to provide annual financial information and material events disclosure. The information must be provided on a timely basis to information repositories, as described below, by the issuer or obligated person, either individually or in combination.

The rule is very flexible and leaves to the issuer and its advisors the determination of what kind of annual financial information and event notices will be disclosed. There is no requirement that issuers prepare financial statements according to generally accepted accounting principles (GAAP) or have their statements audited in accordance with generally accepted auditing standards (GAAS). The Interpretive Release, however, strongly urges issuers to follow GAAP and to have their statements audited in conformance with GAAS. If financial statements are prepared, they must be sent to repositories.

Undertakings may be included in a trust indenture, bond resolution or a separate written agreement. They also may be included in the bond itself. A description of the undertaking for a particular issue also must be provided in the issuer's final official statement.

When does the rule take effect?

For issuers, there are two key dates.

- July 3, 1995—Starting on this date, an undertaking to provide information must be made for newly issued bonds if the bonds are not eligible for an exemption, and the issuer must include a covenant in newly prepared official statements describing the undertaking. This means that issuers must identify the entities about which information will be provided and the type of information to be provided. Issuers must specify accounting principles used, if audited financial statements will be provided and when information will be provided. Material events disclosure must begin on this date for these issuers.
- January 1, 1996—Bonds eligible for the small-issuer exemption do not have to make a "limited undertaking" or include information about their "limited undertaking," which is described below, in their official statements until this date. Material events disclosure must begin for issuers eligible for the small-issuer exemption on this date. For all issuers who must provide annual

financial information, that information must be provided for fiscal years ending on or after January 1, 1996.

How are outstanding bonds affected by the new rule?

Outstanding bonds are not directly affected by the new rule, but issuers should remember that the continuing disclosure required by the new rule also may be applicable to previous issues. Thus issuers should ensure that any disclosure is both accurate and free of material omissions with respect to any bond issue for which the disclosure is relevant. As noted elsewhere, issuers should review the SEC Interpretive Release and determine whether their disclosure practices with respect to prior bonds are sufficient in light of the Interpretation, which took effect immediately upon its release, because it provided an interpretation of disclosure responsibilities under current law.

How is the term "securities" defined for the purposes of the rule?

The definition of security in the federal securities laws is very extensive and includes a variety of instruments, such as notes, bonds, leases, loans, installment sales agreements, take-or-pay contracts, certificates of participation and any other evidence of indebtedness.

What is an "obligated person?"

An obligated person is any person, including a municipal issuer or a conduit borrower, who is committed by contract or other arrangement to support payment of the securities issued. Major customers and major taxpayers are not intended to be covered by the definition. Providers of bond insurance, letters of credit and liquidity facilities are specifically excluded from the definition of obligated person to eliminate the need for issuers to separately obtain and disseminate annual information about such providers.

What is "annual financial information?"

Annual financial information is both financial information and operating data and is the same type of information as is provided by the issuer in the official statement for a bond issue. As indicated above, if an issuer prepares audited financial statements, those statements also must be submitted annually. The SEC emphasizes in its explanation of the rule that operating information is intended to be quantitative in nature. The NFMA has published information that suggests what type of operating data is pertinent for the ongoing analysis of certain types of bonds.

What is an "event?"

An event is an occurrence or a development relating to outstanding securities, the issuer of the securities or an obligated person. The rule requires the submission of notices of 11 events to repositories, if the events are material and applicable to the transaction. The rule also provides that issuers and their advisors may wish to identify material events in the undertaking other than those listed in the rule that could have a material effect on the holders of the bonds. Other types of events may be announced in the same way, such as whether a particular bond issue is affected by pending legislation, and it may be desirable for issuers or obligated persons to supply information to the market that is positive in nature, such as a favorable court decision if an unfavorable decision would have had a material impact on the ability of the issuer to repay outstanding debt. In general, the information should be specific to the issuer or issue.

How is "timely" defined in the rule?

Timely is not defined in the rule. Because of the wide variety of events and issuer circumstances, it is not possible to establish a specific time frame in determining whether an issuer or obligated person provided timely disclosure of a material event. It is necessary to consider the time needed to discover the occurrence of the event, assess its materiality, and prepare and disseminate the notice. While the SEC has expressed a strong preference in the Interpretive Release for annual financial information to be provided within six months after the close of a government's fiscal year, no such requirement exists.

What does the term "material" mean?

Event disclosure is required only if the specified event is material. While there have been numerous definitions of materiality and much discussion of how the term relates to municipal issuers, the most common definitions center on any information that a reasonable investor might consider significant in an investment decision. It does not have to be an event that all investors would consider significant. In many cases, common sense is the best guide to the definition of materiality. The rule clearly leaves to municipal issuers the responsibility to determine materiality, although of course there may be consequences if their determination is later questioned.

If an issuer cannot legally commit to incur expenditures beyond its current fiscal year for the provision of information required by the undertaking, what should the issuer do?

To respond to situations where state law prohibits jurisdictions to enter into contracts that will require appropriations or actions in future fiscal years, the SEC says that the undertaking may include a qualifier. In other words, it would be appropriate to include a condition in the undertaking that provides that the provision of information is subject to appropriation or future action. In the event the appropriation is not made or the action is not taken, disclosure of that fact must be made.

If a bond is credit-enhanced, is it necessary to provide annual financial information and material events disclosure about the underlying credit?

Even if a bond issue is credit-enhanced, information must be provided for those persons for which financial information or operating data is included in the final official statement and that have a contractual or other connection to repayment of the municipal obligations. As discussed above, providers of bond insurance, letters of credit and liquidity facilities are not considered obligated persons for the purposes of the rule.

Should issuers provide information in their disclosure documents about providers of bond insurance, letters of credit and liquidity facilities?

The SEC Interpretive Release states that investors need to be informed about the nature and effects of each significant term of the debt in the official statement, and that includes information about credit enhancements. Additionally, the explanation of the Final Rule provides that financial information and operating data that are material to an offering at the outset generally remain material throughout the life of the security. While the SEC has stopped short of requiring information about these market participants, it has clearly signaled its intentions. The SEC is encouraging all market participants to work together to adopt appropriate

disclosure practices regarding providers of bond insurance, letters of credit and liquidity facilities in primary offering materials and on an ongoing basis in the annual financial information. The SEC has stated that it exempted such providers from the definition of obligated person contained in Rule 15c2-12 because of the representations of the providers that they intend to deposit publicly available reports in repositories or to note where they could be obtained. Therefore, issuers could cross-reference such information in their disclosure documents and indicate where it can be obtained.

Are participants in pools required to provide annual financial information?

The same requirements apply to pool participants as to other issuers, including the small-issuer exemption described below. However, a special rule is provided to determine which pool participants are obligated persons. Flexibility is needed for pools in determining which participants are obligated persons because the composition of a pool may vary over time. Under the rule, bond pools must describe in their official statement, and in the required undertaking, the objective criteria the pool will apply consistently, both in the official statement and on a continuing basis, in determining whether information concerning a pool participant will be provided. While this approach is required for pools, it may be used by other issuers to determine for which obligated persons information must be provided.

The SEC does not specify what objective criteria are to be used, but it says the description of criteria should be clear as to when and how the criteria are applied. It suggests that a percentage of payment support might be used to identify obligated persons. If a participant's involvement no longer meets the established criteria, that participant would no longer be considered an obligated person and annual financial information and material events disclosure would no longer be provided for that obligated person.

Who should undertake to provide the information required under Rule 15c2-12?

Undertakings may be made by the issuer of the securities being offered or by an obligated person for which information is provided in the final official statement. An issuer may provide the undertaking even if the issuer is not an obligated person. An obligated person who is not the issuer also may provide the undertaking. Regardless of who makes the undertaking, the undertaking must constitute a binding agreement. The information also could be provided on behalf of an issuer by another person, such as a trustee.

In a conduit financing where there is a governmental issuer but the borrower is a private party, who is responsible for providing the annual financial information?

As indicated above, information must be provided for all obligated persons and the issuer if the issuer is an obligated person. Thus, someone, either the issuer or the borrower, has to be responsible for providing the information. Of particular importance to governmental issuers is the ability to shift to an obligated person, such as the conduit borrower, the responsibility to provide information on an ongoing basis.

If the private borrower in a conduit financing considers its financial information to be proprietary, must that information be provided to the repositories?

An undertaking to provide information must be made if the conduit bonds are to be underwritten, the undertaking must constitute a binding commitment to provide information, and the information must be sent annually to the appropriate repositories. A private borrower's desire to keep financial information out of the public domain is irrelevant to meeting the requirements of the rule. If a private borrower through a conduit financing is unwilling to covenant to make the necessary disclosure, the requirements of the rule cannot be met, and a conduit issuer should not issue the bonds in question. The SEC does not specify the form or content of the annual financial information. However, it provides that the annual financial information provided must "mirror" the financial information and operating data contained in the final official statement prepared in connection with the offering. This requirement is modified some for issuers and obligated persons, including conduit borrowers, who are eligible for the small-issuer exemption.

How will the information provided by issuers reach the market?

Issuers will send annual financial information to all nationally recognized municipal securities information repositories (NRMSIRs) and to a state information depository (SID) if one exists in the issuer's state. NRMSIRs are private vendors who gather and disseminate information about municipal issuers to the primary and secondary markets. The SEC will permit NRMSIRs to charge reasonable fees for the dissemination of disclosure information, but they may not charge issuers who are submitting annual financial information or events notices. The NRMSIRs are expected to collect fees from the users of the information. Currently, three NRMSIRs exist. A SID may be a public entity or a private organization designated by the state to receive information from all issuers within the state and make that information available promptly to the public. NRMSIRs and SIDs must meet certain qualifications.

Material event notices must be provided to all the NRMSIRs or the Municipal Securities Rulemaking Board Continuing Disclosure Information (CDI) system and to a state information depository if one exists in the issuer's state.

It is expected the NRMSIRs will be operational in time to begin accepting event notices in July 1995 since they now have that capability. At the end of 1994, no state information depositories had been established. For purposes of this article, NRMSIRs, SIDs and CDI are referred to as "repositories."

Should issuers rush to market prior to the July 3, 1995, effective date?

Rushing to issue bonds prior to the effective date of the new provisions of Rule 15c2-12 to avoid making disclosure commitments should be considered carefully in light of the positions the SEC has taken concerning secondary market disclosure in the Interpretive Release. Some advisors argue that, because issuer statements are newsworthy, issuers have no responsibility to provide information until Rule 15c2-12 takes effect and therefore issuers would benefit by rushing issues to market. They contend that issuers do not have a responsibility to disclose information, they only have a responsibility not to provide misleading information and not to omit material information.

The SEC takes the position in its Interpretive Release that, as a practical matter, issuers do not have the option of remaining silent. The SEC further states that, because issuer statements are newsworthy, issuers may face a risk of misleading investors through public statements that may not be intended as the basis of investment decisions but may be reasonably expected to reach the securities market. To guard against such risks for bonds issued both before

July 3, 1995, and thereafter, the SEC recommends that issuers establish practices and procedures to inform the secondary market.

When must annual financial information be provided?

No specific date or time period after the close of the fiscal year is specified by the SEC for the provision of annual financial information. However, the issuer should specify in the undertaking and in the covenant the date when information will be provided. The SEC strongly recommends that the information be made available within six months after the close of the issuer's fiscal year.

Will the submission of a comprehensive annual financial report (CAFR) fulfill an issuer's obligation to provide annual financial information?

It is expected that a CAFR will satisfy the requirements of the rule for many issuers. As long as the information in the CAFR "mirrors" the financial and operating data in the issuer's final official statement(s), it will satisfy the requirement. Issuers may wish to consider expanding the statistical and financial sections of their CAFRs to meet their information needs. The National Federation of Municipal Analysts has published information that suggests what type of operating data is appropriate for the ongoing analysis of certain types of bonds.

Must all the annual financial information be provided in a single document?

There is no requirement for the annual financial information to appear in a single document. Cross-referencing to other documents is specifically authorized as long as they are publicly available and subsequent official statements might satisfy the requirement, in part. To satisfy this "public availability" requirement, the information must be deposited in the appropriate repositories.

Must the same annual financial information be provided every year?

Information must be provided to update the information originally provided in the official statement. However, the annual information requirement is flexible. If an obligated person is no longer responsible for the repayment of the obligations, information is no longer required and the information requirement for that obligated person may be terminated. The rule permits an undertaking to specify only the general type of information to be supplied to accommodate subsequent developments.

What must an issuer disclose about its accounting practices?

An issuer must specify in reasonable detail the basis of accounting used for the preparation of its financial statements in the undertaking. The SEC notes the importance of preparing such information on a consistent basis to enable users of the information to evaluate results and perform year-to-year comparisons.

What happens if an issuer changes its accounting principles or its fiscal year?

The SEC encourages issuers to follow generally accepted accounting principles (GAAP) and would look favorably upon a change to GAAP as long as GAAP were used consistently from that point forward. Issuers should clearly note the change in the basis of accounting in subsequent annual financial information submissions. Moving to a basis of accounting other than GAAP is not prohibited. Other changes, such as a change in an issuer's fiscal year, are not prohibited as long as annual financial information is filed. The issuer would be required to make a notification about the fiscal year change and to indicate when the information would be provided in the future. The undertaking is intended to be written generally to accommodate subsequent developments such as these.

What happens if an issuer experiences delays in the provision of annual financial information?

If an issuer or another responsible party fails to provide annual financial information by the date specified in the undertaking and official statement, a notice should be filed with the appropriate information repositories. The notice should indicate the reason for the delay and when the information will be available.

What happens if annual financial information is not provided?

The undertaking should specify what remedies are available to bondholders and others if required information is not provided. The parties to the transaction are urged by the SEC to enumerate the consequences of such failures in the undertaking to avoid uncertainties of enforcement. The rule requires timely disclosure of the failure of any person to provide annual financial information on or before the date specified in the undertaking. Such disclosures may be made to the trading markets in the same way material events are disclosed.

To bring market pressure to bear on those persons who do not provide required information, the rule requires disclosure in an issuer's final official statement of all instances in the previous five years in which any person providing an undertaking failed to comply in all material respects with any previous informational undertaking. Thus, even though an issuer may shift the responsibility for information disclosure to another party, the issuer must monitor compliance with the information requirements.

Should issuers reduce the amount of information disclosed in their official statements to simplify the annual financial information requirement?

Issuers are cautioned that the SEC is monitoring the municipal market and that reducing the quantity of information provided in disclosure documents in the primary market for this purpose, tempting as it may be, would likely invite more stringent SEC requirements affecting municipal issuers. In the explanation of the Final Rule, the SEC cautions that reliance on the final official statement to set the standard for annual information disclosure should not serve as an incentive to reduce the level of disclosure in final official statements. If issuers pursue this strategy, the SEC could modify Rule 15c2-12 to specify the form and content of issuer disclosures. The SEC is urging full, concise and clear disclosure—not less disclosure. Any attempt to circumvent the rule requirements in this fashion is not advised.

What happens if material events are not disclosed?

If material events disclosure is not made by the issuer, the SEC could employ the enforcement actions it has at its disposal. While it is impossible to predict exactly how the bond market will get such information and respond to it, failure to provide required annual disclosure is likely 1) to be "discovered" promptly by the market and 2) to limit the liquidity of the bonds affected. As noted above, such failure also could undermine the ability of an issuer to sell future issues.

Are statements made by elected officials concerning a jurisdiction's finances considered information that must be sent to repositories?

The rule does not require such information to be sent to the repositories. However, the Interpretive Release reminds issuers that

investors may rely on a variety of formal and informal sources of continuing information, including public statements and press releases concerning a jurisdiction's fiscal condition. The SEC cautions that the antifraud provisions may apply to such information. The SEC encourages the use of standardized mechanisms within each jurisdiction for disseminating information about outstanding debt and future bond issues to avoid confusion about what information is intended to reach investors and the trading market. An example of a standardized mechanism is a commitment to provide annual financial information to information repositories.

Are there any exemptions from the requirements of the rule?

The following securities are exempt from the requirements to provide annual financial information and material events notices:

- securities with an aggregate principal amount less than $1.0 million; and
- securities sold in denominations of $100,000 or more, if the securities are sold to 35 or fewer sophisticated investors, or have a maturity of nine months or less, or the bonds may be tendered at the option of the holder to an issuer at intervals of nine months or less.

The following securities are exempt from the annual financial information requirement but not the material events notice requirement:

- securities with a stated maturity of 18 months or less and
- securities for which neither the issuer nor any obligated person is committed to repay more than $10 million of outstanding municipal securities, including the current securities offering.

The small-issuer exemption is only available to those small issuers who make a "limited undertaking" to provide information. This requirement is described below.

How does an issuer determine if it is eligible for the small-issuer exemption?

To determine if the aggregate $10 million threshold is not exceeded, issuers must add together the total amount of outstanding debt (including the new issue) for which the issuer or an obligated person has repayment responsibilities. If one obligated person who is part of an offering exceeds the threshold, then the entire offering and all obligated persons are subject to the rule requirements. The rule provides that an issuer or an obligated person aggregate outstanding obligations even if some are payable from separate dedicated revenue sources. Therefore, in the case of a general government, it is necessary to aggregate outstanding general obligation debt and revenue bonds.

What information must be provided by the small issuer in order to meet the "limited undertaking" requirement?

To satisfy the limited undertaking requirement, financial information or operating data must be provided to any person upon request, or at least annually to the appropriate state information depository if one exists. At a minimum, the financial information and operating data customarily prepared and made publicly available by each obligated person should be provided. In addition, notices of material events must be sent to the appropriate repositories. The undertaking and the issuer's official statement must describe where and how the information can be obtained. It is not necessary to send the annual financial information to NRMSIRs, but the issuer may find it easier to meet its dissemination responsibilities by sending information to NRMSIRs. For the purposes of this exemption, the information provided need not "mirror" the information presented in the official statement.

Must issuers pay a fee to deposit information in repositories?

As indicated above, the SEC has specifically provided that issuers must not be charged a fee by repositories that will be collecting information from issuers. One cost concern for issuers will be the impact of the requirement to send annual financial information to all NRMSIRs. This requirement may be reviewed, depending on how many NRMSIRs are ultimately established and whether a system of information sharing evolves to reduce the impact of the dissemination requirements on issuers.

Must the information submitted to repositories be filed electronically?

There is no requirement for the information to be filed electronically. It is expected that issuers will have the option to send paper documents to the repositories or to use electronic media. GFOA has consistently called for issuers to have the option to provide the information by the method they choose.

Must issuers now have a trustee for each bond issue?

Trustees are not required for each bond issue. However, issuers are permitted to contractually empower indenture trustees or designated agents to disseminate information that issuers or obligated persons are committed to provide.

Are there any other changes to SEC Rule 15c2-12 that issuers should know about?

The definition of final official statement in the version of Rule 15c2-12 adopted in 1989 has been modified to provide that financial information and operating data for persons, entities, enterprises, funds and accounts must be included in the official statement that are material to an evaluation of the offering and to include disclosure of failures to provide information promised in an undertaking for previously issued bonds.

What new systems and procedures should be put in place to facilitate compliance with the new requirements?

Issuers should consider doing the following:

- develop procedures to identify those officials who will be responsible for identifying events that must be disclosed;
- identify the role of financial advisors, attorneys and others in the disclosure process;
- determine the methods they will use to review events and disseminate information;
- choose the form and content of disclosures; and
- establish a schedule for information dissemination.

Must information about political contributions be disclosed?

As noted above, the Interpretive Release speaks to the need to disclose information about political contributions. In a discussion about official statement disclosure, the SEC says that information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of the offering. According to the SEC, political contributions, if material, could indicate the existence of actual or potential conflicts of interest and should be disclosed.

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