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May 15, 2017

Filed Electronically

Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: **Proposed Amendments to Municipal Securities Disclosure Rule (Rule 15c2–12) under the Securities Exchange Act of 1934, Release No. 34–80130, File No. S7–01–17**

Dear Mr. Fields:

The Vanguard Group, Inc. ("Vanguard")[1] strongly supports the Securities and Exchange Commission's ("SEC") proposal to improve disclosure in the municipal securities markets.[2] As of March 31, 2017, Vanguard funds owned $166 billion in municipal securities on behalf of fund investors including over half a million retail investor accounts. On behalf of these underlying fund investors, Vanguard applauds the SEC's efforts to improve the transparency, accuracy, and timeliness of municipal securities disclosure.

In order to illustrate the importance of the SEC's efforts in this regard, we, first, provide several instances where incomplete and/or delayed information impacted the ability to accurately assess the creditworthiness of an issuer.[3] We then encourage the SEC to consider further enhancements and clarifications to the proposed amendments to Rule 15c2-12 ("Proposed Rule") in order to ensure investors receive sufficient disclosures. In closing, we suggest additional event notices for the SEC's future consideration; the

[1] Vanguard, headquartered in Valley Forge, Pennsylvania, is one of the world's largest mutual fund complexes, offering more than 190 mutual funds, with assets of approximately $4 trillion.
[2] *See Proposed Amendments to Municipal Securities Disclosure,* SEC Release No. 34–80130 (March 1, 2017) ("Proposing Release"), available at https://www.sec.gov/rules/proposed/2017/34-80130.pdf.
[3] The use of the term "issuer" here, and throughout this letter is shorthand for either an issuer or an obligated person who has undertaken to provide continuing disclosure to bond investors and/or is the ultimate borrower of bond proceeds.

disclosure of which would substantially improve the ability to accurately evaluate municipal securities.

I. Gaps in current municipal securities disclosure practices prevent investors from accurately assessing issuers' creditworthiness.

As recognized in the SEC's 2012 Municipal Market Report, the U.S. municipal securities market is highly idiosyncratic and complex, with over 50,000 individual issuers operating under different state or U.S. territory constitutions and tax regimes.[4] These issuers offer securities that are backed by a variety of sources ranging from general obligations, appropriations, tax levies, sales taxes, dedicated taxes, project revenues, and other liens. Collateral for municipal securities varies as well and may consist of mortgages, reserve funds, or nothing at all. Issuers raise capital through diverse structures, including fixed rate bonds, variable rate demand notes ("VRDNs"),[5] cash flow notes, and increasingly, direct placements. Importantly, each debt instrument may have a variety of differing covenants, allowing creditors with stricter covenants to control remedies or trigger events of default, which in turn may result in impairment of the issuer, in rating agency downgrades, or in cross-default of all other debt.

Due to the complexity and variation of debt instruments issued in the municipal market, and the variation, even among the debt issued by the same issuer, transparent, accurate, and timely disclosure of an issuer's *entire debt portfolio including terms of direct placements and bank agreements* is necessary to effectively assess the creditworthiness of any bond or issuer. Unfortunately, as documented by the SEC in the Proposing Release, the current municipal disclosure regime has failed to ensure that investors have access to this critical information.

By way of illustration, described below are instances where investors were disadvantaged by the incomplete disclosure practices of issuers in the municipal bond markets:

- A nonprofit issuer, with roughly half of their outstanding debt in the form of publicly-issued fixed rate bonds and half in a VRDN supported by a bank LOC, violated a financial covenant under the LOC agreements. Under the LOC terms, the covenant failure could have triggered an event of default, requiring immediate repayment of any amounts advanced under the LOC. Further, such event of default would have given the right for the fixed-rate bondholders to deem all of the issuer's fixed-rate bonds immediately due and payable. Noting the issuer's weakening condition and the precarious situation stemming from the bank covenants in the LOC, a rating agency downgraded the issuer by two notches, where they remained on watchlist for further downgrade, potentially to below-investment grade. Termination of the LOC would have triggered collateral

[4] See, Securities and Exchange Commission, Report on the Municipal Securities Market (July 31, 2012). *See also* Municipal Securities Rulemaking Board, Municipal Market by the Numbers (October 2016).
[5] VRDNs are often backed by bank letters of credit ("LOCs") or bond purchase agreements.

posting requirements for the issuer under a swap with that same bank, creating another claim of the issuer's resources away from the issuer's fixed rate bondholders.

Ultimately, the bank waived any events of default, and renegotiated the terms of the LOC. Outside of information provided indirectly through the rating agency, no information regarding terms of the LOC, swap, covenants, or periodic covenant performance reports was provided to bondholders.

- During a recent state budget impasse, many school districts borrowed from banks to meet operating expenses due to the absence of state appropriated funds. In one instance, news reports and other publicly available sources reported that a school district issuer applied for and drew upon a $10 million line of credit. Although this new borrowing significantly increased the issuer's level of outstanding debt, and may have carried new covenants or more restrictive acceleration provisions, there were no material event disclosures made on Electronic Municipal Market Access System ("EMMA") regarding the borrowing.

- Following years of operating losses, declining liquidity, and rating agency downgrades, another issuer sold several parcels of real estate, drew on lines of credit, then entered into a taxable direct placement with a par amount representing almost one-third of the existing bonded debt. The direct placement was over-collateralized with the issuer's other real estate and was executed two months into the issuer's fiscal year. The only notice of this direct placement on EMMA occurred with the issuer's financial statements for that year, almost a year and half after the direct placement was incurred, and did not include some of the most material information necessary to investors, such as the mortgaged property or the covenants of the direct placement.

- A municipal issuer planned to issue a bond in the securities markets. However, due to tepid reception for the issuer's bonds, the issuer decided to forego the bond markets and instead issued a direct placement. No notice of the direct placement was made to the market to inform the issuer's existing bondholders of the new debt.

Compounding the problems of incomplete disclosure, under existing requirements issuers often provide infrequent or delayed financial reports to investors. As part of the SEC's Municipalities Continuing Disclosure Cooperative Initiative ("MCDC Initiative"), it was noted that several issuers were overdue in publicly posting required annual reports for periods ranging from months to years.[6] This failure to provide the market with timely financial information is not a new concern. The SEC's 2012 Municipal Market Report identified issuers' failure to comply with their continuing disclosure obligations as a

[6] *See* Proposing Release, pg. 9.

major challenge for investors seeking information about their municipal bond holdings.[7] In addition, public securities such as VRDNs supported by LOCs are being replaced with direct placements outside of the public securities markets, creating even further information disparities.

Incomplete, infrequent and delayed disclosure creates inefficiencies and uncertainty in the market. Studies have shown that these delays increase issuers' borrowing costs.[8] If bondholders have incomplete and unreliable financial information, then they are unable to make fully informed investment decisions. In fact, even when there is positive news issuers often fail to make timely disclosures. For example, after an issuer sold some real estate at a significant gain, it resulted in an improved balance sheet and ratings upgrade. However, no information regarding this material improvement was disclosed on EMMA at the time of the real estate sale.

Thankfully, the Proposed Rule seeks to take a step toward remedying these incomplete and untimely disclosure deficiencies.

II. We encourage the SEC to consider further enhancements and clarifications to the Proposed Rule in order to ensure that investors receive sufficient disclosure.

The Proposed Rule takes steps to close these disclosure gaps by adding required event disclosures designed to provide investors with more timely information regarding an issuer's creditworthiness. We believe the Proposed Rule would be further enhanced by:

1. Including financial covenant performance reports and financial statements provided to other creditors as required disclosures in the first proposed event notice.[9]
2. Requiring disclosure of any terms in connection with a material financial obligation that will affect security holders.
3. Clarifying the treatment of contingent liabilities by including notice of: a) the initial conversion of a contingent liability into a current financial liability; and b) an unscheduled termination of a contingent liability regardless of whether it is related to financial difficulties.

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[7] Securities and Exchange Commission, Report on the Municipal Securities Market (July 31, 2012), pg. 74.
[8] Edmonds, C.T., et al. Does timeliness of financial information matter in the governmental sector?. J. Account. Public Policy (2017), http://dx.doi.org/10.1016/j.jaccpubpol.2017.02.002.
[9] See Proposing Release, pg. 36 requesting whether there are other events that should be included in subparagraph (b)(5)(i)(C)(15) of the Rule which proposes to require an event notice for the 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.

1. ***Include financial covenant performance reports and financial statements provided to other creditors as required disclosures in the first proposed event notice.***

Currently, creditors lending to issuers in direct placements outside of the public bond market or banks supporting issuers through LOCs and standby bond purchase agreements often require more frequent and/or more current information, including periodic financial covenant performance reports. This creates a significant disparity of reporting between the public securities' markets and the bank/private lender markets. Delayed or incomplete reporting to investors also generates uncertainty about an issuer's financial obligations as well as the potential impairment of bondholders' rights or access to collateral, which results in an inefficient secondary market. It is important for investors to have access to or the ability to compile updated debt service schedules reflecting all new debt. The examples above demonstrate that information provided to other creditors, even on a private basis, can have profound impacts on the issuer's other securities and overall creditworthiness, and this information should be disclosed.

Consequently, we believe the first proposed event notice would be further enhanced if it clearly required an issuer or obligated person to simultaneously disclose the same covenant compliance information and financial reporting provided to other creditors to the public via EMMA. The clarity and simplicity of "parity disclosure" removes potential confusion in determining a materiality or "reflecting financial difficulties" threshold, both of which are subject to interpretation. Ironically, banks often require similar parity disclosure in their loan agreements requiring all information provided to bondholders, in addition to requiring unique financial covenant performance reports and financial statements.

A few issuers, particularly certain not-for-profit healthcare and university issuers with significant amounts of variable-rate debt supported by bank LOCs and/or bank private placements, voluntarily provide quarterly financial statements, mark-to-market swap information, and copies of bank's quarterly covenant compliance reports on EMMA. When all investors have access to the same disclosure as other creditors, investors can confidently trade bonds without uncertainty that an issuer is close to triggering a covenant breach, causing a cross default to public bonds, or utilizing a line of credit due to strains on liquidity. Requiring parity disclosure levels the playing field and promotes efficient markets.[10]

2. ***Require the disclosure of any terms in connection with a material financial obligation that will affect security holders.***

The first event in the Proposed Rule could be further enhanced by striking the second "if material" reference. As drafted, the provision requires disclosure of terms in

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[10] In the event that additional disclosure requirements are not in scope for the final rule, we believe it would be useful for the SEC to clarify in the adopting release that "other material financial obligations" always include obligations for which an issuer is providing covenant compliance reporting.

connection with a material financial obligation "that affect security holders." We believe any term that affects security holders is inherently material to security holders, rendering a second materiality analysis unnecessary.

3. ***Clarify the treatment of contingent liabilities by including notice of: a) initial conversion of a contingent liability into a current financial liability; and b) unscheduled termination of a contingent liability, whether or not related to financial difficulties.***

The existence, use, and terminations of contingent liabilities constitute material information that is necessary in order to assess the creditworthiness of specific securities. Thus, we advocate for the final rule to incorporate conversions and terminations of contingent liabilities within the definition of "incurrence" of a financial obligation.[11]

When contingent liabilities convert to current financial obligations, the final rule should clarify that such events are "incurrences" of financial obligations. For instance, when there is an initial draw on a line of credit used for working capital purposes, this may signal a response to a liquidity problem, or a routine event, depending on the circumstances. Similarly, an initial liquidity advance on a LOC represents the conversion of a contingent liability into a current liability and provides significant information to investors. This could require the issuer to unexpectedly draw on cash reserves. Again, this information is important to assess the issuer's current liquidity and credit profile, but the draw on the LOC may reflect market conditions that have nothing to do with financial difficulties of the issuer.

Similarly, the non-scheduled termination of a contingent liability is potentially critical information to an investor, whether or not this termination "reflects financial difficulties" of an issuer. For example, an issuer may partially rely on a line of credit to purchase unenhanced VRDNs that have been tendered by investors. However, the issuer or bank may have terminated that line of credit for business reasons other than the issuer's financial difficulties. Under the Proposed Rule, as currently drafted, issuers would not be required to inform investors of this material change in access to liquidity. An additional example of the importance of disclosing non-scheduled terminations is when a swap is terminated prior to maturity. The swap termination may be due to the financial difficulties (e.g., downgrade) of the swap counterparty, rather than the issuer's financial difficulties, nevertheless requiring termination payments by the issuer that impact the issuer's creditworthiness. Another example of a potential unexpected draw on cash reserves that may not reflect financial difficulties of an issuer is when an issuer guarantees a financial obligation of a third party, and that guarantee is exercised. This conversion of a contingent liability into a current liability impacts an issuer's liquidity and balance sheet. Additionally, each of these scenarios creates the potential for further information disparity among market participants and market inefficiency.

[11] These important notices regarding contingent liabilities could also be separate event notices.

III. Additional event notices would further enhance investor protections and facilitate more efficient markets.

We also agree with other investor industry groups that there are further opportunities to improve the Rule 15c2-12 disclosure regime.[12] For example, often with debt issued by hospitals, notification is typically only provided after obligated group changes are effective. For example, when a hospital signs a purchase/sale agreement or memorandum of understanding to merge with another hospital that will result in future changes to a bond's obligated group, significant time could pass before the obligated group changes are effective that trigger disclosure to investors under the current requirements. This delays investors' ability to assess the credit impact of changing the obligated group members. Additionally, documentation related to escrow agreements should be posted, as the types of securities held could impact an assessment of the bond's creditworthiness. Finally, we support inclusion of a "catch-all" event notice. These additional event notices (as well as others set forth by investor industry groups) would continue to foster transparency and efficiency in the municipal market.

[12] See letter from the Investment Company Institute regarding Proposed Amendments to Exchange Act Rule 15c2-12 (May 15, 2017). See also letter from Asset Management Group of the Securities Industry and Financial Markets Association regarding Proposed Amendments to Exchange Act Rule 15c2-12 (May 15, 2017).

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We commend the Commission for addressing the need for improving the availability and quality of municipal securities disclosure and appreciate the opportunity to comment on the proposal. The Proposed Rule is an important step towards enhancing investor protections and ensuring material information is provided to the market. If you have any questions or would like any additional information, please contact Christyn Rossman, Senior Counsel, at [redacted].

Sincerely,

/s/ Christopher Alwine

Christopher Alwine
Head of Municipal Money Market and
Bond Groups
The Vanguard Group, Inc.

cc: The Honorable Jay Clayton
Honorable Michael S. Piwowar
Honorable Kara M. Stein

Jessica Kane, Director, Office of Municipal Securities