

March 8, 2022

Ronald W. Smith, Corporate Secretary
Municipal Securities Rulemaking Board
1300 I Street NW, Suite 1000
Washington, DC 20005

Delivered electronically

Dear Mr. Smith,

The Bond Dealers of America (“BDA”) is pleased to provide comment on MSRB Notice 2021-17, “Request for Information on Environmental, Social and Governance (ESG) Practices in the Municipal Securities Market” (the “Notice”). BDA is the only DC-based organization exclusively representing the interests of securities dealers and banks focused on the US fixed income markets.

ESG investments are the fastest growing segment of the financial services industry.¹ BDA’s members’ investor customers are increasingly demanding ESG investments for their portfolios. Some issuers have responded by designating their new issues as “ESG” bonds, or using some similar designation, and marketing them to specific investors. This trend raises regulatory and compliance issues, as the MSRB has recognized in the Notice. Still, we are generally pleased with the manner in which ESG standards and practices are developing and evolving. We do not believe that significant action—regulatory or non-regulatory—by regulators with respect to ESG labeling is called for. As the ESG segment of the municipal market evolves and matures, better data and tools will continuously emerge.

An important consideration in regard to ESG standards and practices in the municipal market is the uniqueness of municipal securities and municipal credits among other sectors of the capital markets. The majority of outstanding municipal securities financed essential public services like water and sewer systems, transportation infrastructure, schools and universities, hospitals and others. A majority of municipal securities are supported either by taxing authority or fees paid for essential services, resulting in the strongest credit market in the world outside the market for sovereign debt. In examining ESG practices in the municipal market, we urge the MSRB and other regulators to continually recognize these unique features and how they relate to ESG labeling. Moreover, there is a diversity of opinions within the investor world on the importance of ESG standards and which standards to follow. We urge the Board and other regulators to not interfere with investors’ ability to make those judgements for themselves in the context of ESG labeling.

ESG Bonds and MSRB authority

The MSRB does not have statutory authority over issuer practices with respect to new-issue bonds, including the issuer practice of designating bonds as “ESG.” While the Board is charged with protecting

¹ Cam Simpson, Akshat Rathi, and Saijel Kishan, “The ESG Mirage,” *Bloomberg*, December 10, 2021, www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/.

issuers and investors, that authority is limited to the regulation of municipal securities dealers and municipal advisors, neither of whom have control over issuer disclosure documents or issuer ESG designation practices. This lack of authority means there is no meaningful action the MSRB could take to address any hypothetical issues associated with issuer ESG designations, so the purpose of the Notice is unclear.

In the Notice the Board cites the RFI “as part of its broader engagement on ESG trends in the municipal securities market.” The Notice also states the Board is seeking input on “(1) the disclosure of information regarding ESG-related risk factors and ESG-related practices (‘ESG-Related Disclosures’) and (2) the labeling and marketing of municipal securities with ESG designations (‘ESG-Labeled Bonds’).” But nowhere in the Notice does the Board discuss what, if any, actions are available to the MSRB to address whatever issues arise from the Board’s inquiry. While BDA questions the appropriateness of issuing a notice and seeking stakeholder input on an issue that falls outside the Board’s authority, we offer our answers to the questions posed in the Notice.

Questions posed to dealers

Underwriting ESG-labeled bonds and compliance

Underwriting ESG-labeled bonds could raise unique and challenging compliance issues, including with respect to diligence duties. Our members are beginning to see that in some cases, an ESG designation on a bond may affect pricing, suggesting that the designation is material information.

Dealers are bound to have a reasonable basis to believe the truthfulness of statements made by issuers in the context of bond sales. This underwriter duty raises potential questions in relation to bonds purported to be “green,” including: What standards has an issuer followed in self-designating a bond as green? If the bond was designated by a third-party evaluation service, what standards did they use? Are those standards compatible with what US regulators expect with respect to ESG impacts of investments? Who is verifying that the issuer or third-party designation service is applying ESG standards correctly? These questions are difficult enough in the context of bonds designated as green. They are even more complex for bonds designated as social, where evaluation standards may be more subjective. There is no American standard for characteristics necessary to place an ESG label on a bond. Some firms have reported that they see an ESG designation as a “red flag” on an bond because it potentially exposes the underwriter to additional risk which may be difficult to mitigate given the uncertainties associated with ESG designations.

For these reasons dealers should be able to rely on issuer statements and third party opinions with respect to diligencing ESG bonds, including the opinions of third-party designation services or issuer officials who self-designated the bond. In addition, dealers should not be required to define ESG standards. ESG labeling is an entirely issuer-driven function for marketing purposes. Underwriters do not own or control the standards for ESG labeling and should not be liable for any irregularities that arise as a result of labeling standards applied by issuers and third-party experts.

Prioritizing ESG orders

For decades many municipal issuers have prioritized retail orders in their bond sales. Issuers specify retail order periods and define which investors are eligible to buy bonds during that period. Unfortunately, retail order periods have generated an extraordinary number of enforcement cases

making findings that dealers failed to follow issuer guidelines during retail order periods or that investors engaged in “flipping,” i.e., buying bonds during retail order periods and selling those bonds quickly for a profit once the bonds become “free to trade.”

Now we are beginning to see order priority granted to “ESG investors” on some transactions as well. We believe this trend has the potential to be an even more troublesome enforcement issue than retail order periods. There is no standard definition of ESG investor, and issuer definitions may not be adequate to distinguish among customers. Issuer definitions can vary from deal to deal even with the same issuer. This raises thorny compliance questions regarding, for example, the action that dealer should take if prioritizing ESG orders causes the issue to price worse for the issuer than marketing to general investors.

It is important that issuer priority of orders is explicit and clear in identifying and defining what an ESG investor is. There is no standard, regulatory or otherwise. Regulations should not make underwriters the arbiters of who qualifies for ESG order priorities.

Secondary market trading

One significant issue associated with secondary market trading of ESG-labeled bonds is reliance on the ESG designation. A bond labeled ESG may have received that designation years or decades before a secondary market trade. Unlike credit rating agencies, which monitor the credit quality of issuers throughout the life of the bond and change credit ratings as issuers’ financial conditions change, third-party ESG designators do not follow the performance of bond-financed projects throughout their lives. An ESG designation applied at issuance could be stale or even inaccurate at the time of a trade. Dealers quoting and trading ESG bonds in the secondary market have no way of knowing whether a bond still meets ESG standards years after issuance. Moreover, there are trillions of dollars of bonds outstanding which were issued before the trend of ESG labeling caught on. Some of those bonds may meet ESG standards and may be suitable for investors who are explicitly seeking ESG investments, but traders have no way of knowing.

Dealers should not be expected to determine whether a bond with an ESG label trading in the secondary market really meets the criteria for an ESG investment or is currently accurate. And Sophisticated Municipal Market Participants (SMMPs) should be expected to make their own determinations as to whether a bond trading on the secondary market meets their ESG requirements regardless of whether it is labeled ESG.

Questions posed to all

Systemic risks

Although it is challenging to quantify climate risks, there may be systemic or sectoral risks associated with climate change in general and the effects that a warming climate can have on state and local governments. We do not believe, however, that ESG labeling results in systemic risks.

In terms of what the MSRB might do to improve the transparency and application of ESG standards, one consideration would be to identify third-party verifiers/designators and publish information about them on EMMA, including a description of the standards they apply to designating investments. It is also important for regulators to distinguish municipal securities from corporate bonds and equities in the context of ESG labeling. State and local government do not necessarily face the same environmental,

social and governance issues as corporations. It is also important for regulators and market participants to recognize significant differences among municipal securities issuers with respect to ESG issues and risks they face. A low-lying coastal city, where climate risks are direct and identifiable, is different from issuers where the effects of climate change are general and amorphous.

ESG voluntary evaluation standards

The International Capital Markets Association (ICMA) Green Bond Principles² are the de facto standard for environmental bonds in the municipal market. There are no comparable standards for social and sustainability bonds.

BDA believes strongly that ESG standards should be voluntary and remain in the realm of industry and market groups as opposed to being imposed through regulation. While better standardization of ESG principles would be welcome, BDA believes those improvements will come organically as the ESG sector evolves and matures. Moreover, as stated above, ESG labeling is an issuer function. Issuers make the decisions on labeling and completely control the process of determining what standards and criteria to apply to labeling a bond. The responsibility and liability associated with ESG labeling should rest completely with issuers.

Industry ESG initiatives

BDA believes that industry initiatives and criteria established by third party standard setters can provide serious and meaningful standards for ESG-labeled bonds. While there is still no universal standard for ESG bonds, clear definitions and distinctions are emerging. For example, evaluation criteria for climate bonds tend to be more objective and quantitative while criteria for social and sustainable bonds tend to be more subjective. These standards will continue to be refined and developed by private third parties. Intervention by regulators or self-regulatory organizations is not needed.

New tools related to ESG bonds are steadily emerging. For example, Build America Mutual, the monoline bond insurer, in 2018 announced the initiation of BAM Greenstar, a climate bond assessment program.³ In another example, ICE Data Services announced last year that they had acquired risQ, a company focused on quantifying climate risk.⁴ Branded as “ICE Climate Risk,” the product allows users to “quantify climate risk exposure and make strategic decisions across municipal portfolios by maturity, obligor or geographical boundary.” Initiatives like these two and others will continue to emerge and evolve and will provide a means for investors and others to evaluate their investments through an ESG lens.

² International Capital Markets Association, “Green Bond Principles,” June 2021, www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Green-Bond-Principles-June-2021-140621.pdf.

³ Build America Mutual, “Build America Mutual Launches BAM GreenStar Assessment to Identify Municipal Green Bonds,” press release, October 2, 2018, buildamerica.com/news/build-america-mutual-launches-bam-greenstar-assessment-to-identify-municipal-green-bonds/.

⁴ Intercontinental Exchange, “ICE Expands Climate Change and Alternative Data Capabilities With Acquisitions of risQ and Level 11 Analytics,” press release, December 9, 2021, ir.theice.com/press/news-details/2021/ICE-Expands-Climate-Change-and-Alternative-Data-Capabilities-With-Acquisitions-of-risQ-and-Level-11-Analytics/default.aspx.

Unequal access to data

We do not believe “competing ESG data” create meaningful investor confusion. There are public sources of climate data that could mitigate informational asymmetry with respect to ESG bonds. One example is the Federal Emergency Management Administration’s National Risk Index which, according to its developers, “is a new, online mapping application from FEMA that identifies communities most at risk to 18 natural hazards.”⁵ There are also data vendors in addition to ICE who market ESG data and tools to institutional investors. We do not see a role for the MSRB in distributing ESG-related data.

Comparison with other financial markets

The availability of ESG-related information in other sectors of the capital markets does not influence the functioning of the municipal market. Municipal bond investors in general recognize that disclosure standards differ between the municipal and corporate bond markets and do not expect the same type of disclosures from municipal issuers. The municipal market throughout its history has operated with a discrepancy in disclosure standards without significant disruption. The same would apply to any discrepancy in disclosure standards related to ESG.

ESG indicators on EMMA

Last year the MSRB announced a new feature on the EMMA new issue calendar, a field for whether the bond issuer has self-designated the bond as green, climate, social, or sustainable and a second field for whether the bond has been certified by a third-party verifier.⁶ We believe this is a constructive initiative, but we do not believe it is a major factor in expanding ESG transparency.

EMMA

We do not believe there are significant changes to the EMMA web site which the MSRB could implement based on existing sources of data and information which would enhance access for investors to ESG-related information. We do not believe in general that there is a significant role for regulators with respect to ESG labeling. There is nothing “broken” in regard to the developing practice of placing ESG labels on bonds, and no regulatory response is justified.

In summary, BDA believes the following principles should guide the Board and other regulators in regard to evaluating the state of standards and practices related to ESG labeling.

- The Board should take great care not to wander into areas of regulation which do not fall under its jurisdiction, especially issuer disclosure practices, including ESG labeling.
- The current state of ESG standards and practices is generally good. Tools and data available to investors to evaluate ESG investment continue to improve and evolve. There is no need for regulatory intervention in this area.

⁵ Federal Emergency Management Administration, “National Risk Index for Natural Hazards,” www.fema.gov/flood-maps/products-tools/national-risk-index.

⁶ Municipal Securities Rulemaking Board, “New EMMA Feature Helps Investors Identify Green, Social, Climate and Sustainable Bond Investments,” press release, October 25, 2021, www.msrb.org/News-and-Events/Press-Releases/2021/EMMA-ESG-Indicator.

- ESG labeling is an issuer function. The responsibility and liability associated with ESG labeling standards rest with state and local government and third-party designators, not with underwriters.

BDA is happy to provide these comments on the Notice. As always, please call or write if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Decker", written in a cursive style.

Michael Decker
Senior Vice President