November 3, 2022

Marc Oorloff Sharma
Chief Counsel
Office of the Investor Advocate
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SEC Office of Investor Advocate Report on Activities Fiscal Year 2022

Dear Mr. Sharma:

The Municipal Securities Rulemaking Board (MSRB) appreciates the opportunity to respond to the SEC Office of the Investor Advocate's request for information on products and practices that may pose risks to individual investors in the municipal securities market as part of its Report on Activities for Fiscal Year 2022. As the self-regulatory organization that oversees the $4 trillion municipal securities market, our highest priority is to fulfill the MSRB's congressional mandate to protect investors, municipal entities, and the public interest by promoting a fair and efficient market. The MSRB's Strategic Plan envisions investor protection by modernizing market rules and regulation, enhancing market transparency through technology, fostering innovation through market data, and upholding the public's trust in this market that enables investment in the nation's public infrastructure.

The MSRB believes that the following issues raise potential investor protection concerns: (1) macroeconomic conditions; (2) deeply discounted bonds; (3) exempt limited offerings; (4) mutual fund flows; (5) asymmetric information; and (6) environmental, social and governance (ESG) considerations.

Macroeconomic Conditions
The municipal bond market, like all fixed income markets, has seen a significant rise in interest rates in 2022. This sustained and significant rise in rates follows a period of many years where tax-exempt yields remained at historically low levels with limited volatility. At the end of September 2022, benchmark tax-exempt AAA yields reached a new high, not seen since 2011. Since interest rates and bond prices have an inverse relationship, as interest rates have risen, investors have seen the value of their municipal bond portfolios as well as the value of their municipal bond mutual funds and Exchange Traded Funds (ETFs) decline in 2022. The MSRB's Education Center (www.msrb.org/EdCenter) has numerous educational materials on interest rate risk and the relationship between yields and prices. The MSRB will continue to monitor the impact of rising rates on the municipal securities market and educate investors and other market participants on some of the associated risks.

Deeply Discounted Bonds

With the significant rise in interest rates in 2022, there has been a dramatic rise in tax-exempt municipal bonds purchased by investors in the secondary market at a significant discount to par. When this occurs, the bonds may have "market discount." Although purchasing bonds at a market discount can be a logical part of a portfolio strategy, this practice also could result in significant tax implications for such investors. Internal Revenue Service (IRS) rules determine whether the price appreciation (or accretion) of a bond that is purchased at a discount will be taxed at the ordinary income tax rate, or if it will be taxed at the capital gains tax rate. Generally, if the discount falls within a specified *de minimis* threshold, it is deemed to be too small to be treated as a market discount. As a result, the appreciation upon the sale or exchange of the bond will be treated as a capital gain rather than as ordinary income.

Unless rates decline dramatically in 2023, the MSRB expects the level of bonds purchased at a discount to remain at elevated levels compared to pre-2022 levels. As a result, investors may be more likely to transact in bonds that will have a different market discount tax treatment than in a falling interest rate environment. This is especially important in the tax-exempt market because some individual investors may not expect any tax consequences from their purchases. Individual investors should consider consulting with their tax professional to help determine the appropriateness of purchasing bonds at a discount to par.

Investors also should be mindful that bonds with market discount can be less liquid than similarly rated bonds that are trading at par or at a premium to par. Although individual investors may not believe they will need to sell a bond before it matures or is called, various factors could cause an investor to look to sell a bond prior to maturity. This is especially true for bonds with longer maturities. The longer a bond has until maturity, the more likely it is that financial factors could cause an individual investor to decide to sell a bond. So, if an individual investor decides to sell a bond and the market discount continues to fall outside of the *de minimis* threshold, there could be fewer purchasers (because of the tax consequences) for the bond compared to bonds trading at par or at a premium which could negatively impact the price the investor would receive for its bonds.

Since 2016, the MSRB expressly has required dealers to disclose to their customers, at or prior to the time of a transaction in municipal bonds, the fact that a municipal security bears market discount, which may significantly affect its tax treatment.[1] As interest rates rose throughout 2022, the MSRB published an educational document that focuses on the potential impact to investors of the current market environment on bond prices, liquidity and tax implications from buying certain types of municipal bonds in the secondary market.[2] The MSRB is currently conducting a retrospective review of MSRB Rule G-47, on time of trade disclosure, including the consideration of codifying interpretive guidance pertaining to market discount disclosure.

---

[1] See MSRB Interpretive Notice Time of Trade Disclosure—Disclosure of Market Discount (November 22, 2016).
[2] See MSRB, Tax and Liquidity Considerations for Buying Discount Bonds (March 17, 2022).

Exempt Limited Offerings
SEC Rule 15c2-12 generally requires an underwriter of municipal securities to obtain and review an official statement that is "deemed final" by the issuer, to contract with the issuer for delivery of official statements and to deliver the official statements to investors at or prior to specified times. The underwriter also is prohibited from purchasing or selling the bonds until it has reasonably determined that the issuer (or obligated person) has agreed to certain undertakings related to continuing disclosures, such as providing to the MSRB's EMMA® website (www.emma.msrb.org) (EMMA) certain annual financial information and operating data, and notices about specified events, such as payment defaults and credit rating changes. Both official statements and continuing disclosures are made publicly available for free on EMMA.

Rule 15c2-12 contains certain exemptions including but not limited to an exemption for offerings commonly referred to as "exempt limited offerings." Among other things, this exemption requires that the securities are sold in authorized denominations of $100,000 or more to persons that the underwriter reasonably believes are capable of evaluating the merits and risks of the prospective investment and are not purchasing for more than one account or with a view to distributing the securities. We understand that these bonds may sometimes be purchased by investors in the secondary market. These investors may not be aware that the official statement and continuing disclosures that are required for most municipal bonds are not required with respect to these particular bonds.

As noted above, the MSRB is currently conducting a retrospective review of MSRB Rule G-47 on time of trade disclosure. In connection with that retrospective review, the Board has authorized the publication of a proposal to codify certain existing guidance pertaining to a dealer's time-of-trade disclosure obligations and to propose certain new specified disclosures that would be required to be disclosed to a customer at or prior to the time of a municipal bond transaction. These new specified disclosures would include draft obligations to disclose to a customer the fact that an official statement is not available on EMMA and that continuing disclosures are not required to be made with respect to a customer's bonds. If approved by the SEC, these draft obligations would require disclosures in connection with secondary market purchase and sale transactions involving exempt limited offerings and other offerings that are exempt from the requirements of SEC Rule 15c2-12.

Mutual Fund Flows
In its letter to the SEC Investor Advocate for Fiscal Year 2021, the MSRB identified the municipal securities market's increasing dependence on tax-exempt mutual fund flows as a potential risk for individual investors. Mutual funds have provided a critical source of liquidity for the market and have helped it to manage large supplies of new bond issuances over the years. However, the significant increase in mutual fund inflows prior to 2022 made the market more reliant on this source of capital, especially for long-dated securities.

When interest rates rise, as they have in 2022, bonds prices fall. And when bond prices fall, the Net Asset Value (NAV) of a mutual fund declines as well. In 2022, individual investors redeemed tax-exempt mutual fund shares at an unprecedented level. According to the Investment Company Institute (ICI), prior to 2022, tax-exempt mutual funds had not seen a full year of outflows since 2013 and there have only been two years with outflows since 2007. Mutual funds also saw inflows of more than $217 billion from 2019 to 2021. In 2022, we have seen consistently large outflows from tax exempt mutual funds.

The unprecedented outflows in 2022 forced mutual funds to sell bonds in order to meet the redemptions from their funds and greatly reduced their demand for bonds in the primary and secondary market. This selling pressure contributed to the volatility in the market and the increase in yields. We expect the performance of the municipal bond market in 2023 to be greatly influenced by the flows into or out of tax-exempt mutual funds.

There are a variety of investment products (individual bonds, mutual funds, ETFs, *etc.*) investors can buy to access the municipal securities market. Although the value of these products will be influenced by similar factors and their prices will generally move in the same direction as mutual funds, there are unique structures, risks and benefits associated with each product. The MSRB continues to believe it is important for individual investors to understand the differences in these investment products in order to help them make the best investment decisions to meet their financial objectives. In 2022, the MSRB will be publishing an investor education primer highlighting the various investment products investors can buy to access the municipal securities market, including the key risks and benefits associated with each product.

Asymmetric Information
With the advent of "Big Data" and powerful technology solutions such as artificial intelligence, machine learning and natural language processing, the information gap between individual investors and institutional investors is at risk of growing larger. The MSRB is considering various ways in which it could help bridge this gap with enhancements to EMMA and is in the midst of a multi-year system modernization project that will allow users to customize EMMA to better meet their needs. The MSRB has also launched EMMA Labs, a "fintech" sandbox available to anyone that creates an account, which includes access to a prototype search engine for testing and development purposes to execute sophisticated searches across the hundreds of thousands of unstructured disclosure documents. We will continue to invest in modernizing our technology systems to level the playing field and better equip all investors to make informed decisions.

Environmental, Social and Governance Considerations
Investor demand for climate and other ESG-related information has increased, and there are growing trends toward sustainable investing, socially responsible investing, and impact investing in the municipal securities market. As a result, the MSRB invited feedback on these trends by publishing a request for information on ESG practices in the municipal securities market. Fifty-two commenters submitted responses – representing a cross-section of

viewpoints from municipal issuers, investors, regulated entities, and other stakeholders across the municipal securities market.[3]

Among other themes, several commenters noted the potential risks posed to investors and other market participants by the lack of uniform standards related to ESG practices, including emerging practices related to the labelling of municipal securities as green bonds, social bonds, climate bonds, and other ESG signifiers (*i.e.*, "ESG Labels"). Commenters on the MSRB's request for information indicated that the lack of uniform practices associated with ESG Labels in the municipal securities market may cause confusion for unsophisticated retail investors, who may not fully appreciate that the statutory framework for disclosure grants municipal issuers significant discretion in defining and applying ESG Labels. In addition, while municipal issuers' disclosure documents must include any material ESG-related information required under existing standards, many investors are seeking additional non-credit related disclosure, including information about the use of bond proceeds and attributes of the municipal issuer. The MSRB will continue to monitor and engage with stakeholders on these important and still-evolving ESG practices, paying careful attention to their implications for investors in terms of market fairness, efficiency, and transparency.

The MSRB appreciates the opportunity to provide its perspective on risks to individual investors in the municipal securities market. We look forward to working with the Office of the Investor Advocate to increase awareness and understanding of these risks through education and research. Please do not hesitate to contact me or John Bagley, Chief Market Structure Officer, at (202) 838-1307, if we can be of any further assistance.

Sincerely,

Mark T. Kim

Mark Kim
Chief Executive Officer

---

[3] The MSRB's Request for Information may be accessed at https://msrb.org/sites/default/files/2021-17.pdf. The fifty-two comments submitted in response may be accessed at https://msrb.org/Regulatory-Documents?f%5B0%5D=msrb_publication_date%3A2021&f%5B1%5D=regulatory_documents%3A106.