CAP

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March 08, 2022

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

VIA Electronic Filing

Re: MSRB Request for Information on Environmental, Social and Governance Practices in the Municipal Securities Market.

Dear Mr. Smith,

The Center for American Progress (CAP) is an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans. As part of our mission, we seek to protect investors, worker savings and retirement funds, and the public from risks associated with climate change, inadequate human capital management, lack of workforce diversity, and other environmental, social and governance matters. CAP also maintains a 401(k) retirement plan for all of its employees.

Retail and institutional investors who are interested in purchasing securities increasingly want more information about potential risks associated with environmental, social, and governance (ESG) factors, including vulnerability to climate-related risks, human capital management practices, board and workforce diversity, and political spending, among others.

The growth in investor demand for securities with positive ESG attributes has outpaced regulatory requirements, leading to two separate challenges. First, issuers are not providing adequate risk disclosures. With respect to climate change, these risks include physical risks, such as fires, floods, storm surge during hurricanes, sea level rise, drought, and extreme heat; and transition risks, such as changing federal policies around combustion of fossil fuels, consumer demands, and societal norms. While many issuers include some representations about the sustainable or climate-friendly aspects of the underlying project, often this is boilerplate language and is not audited for reliability.

Investors in municipal securities may be blindsided if climate-related or other ESG risks materialize that were not anticipated or disclosed by issuers. For instance, rising costs could come from facility damage tied to a weather event or escalating capital needs tied to climate adaptation. Falling revenues could result from a severe service outage or changing demographic and economic production trends as residents and businesses alike respond to the pressures of climate change. Retail investors are particularly vulnerable to these risks, including with respect to municipal securities embedded in larger funds.

Second, and equally problematic, many municipal bonds are labeled as green, sustainable, or ESG based on frameworks that do not include environmental performance standards grounded in climate science or environmental justice performance standards developed through robust community input. In fact, many purportedly green bonds rely on a process that is essentially self-certification. The process begins with a municipal issuer developing their own green framework that may or may not have any grounding in science or quantitative measures. Next, the issuer contracts with a third-party to attest to the fact that a particular issuance conforms to the issuer's own green framework, resulting in the bond being labeled and marketed as green and sustainable. This de facto self-certification undermines investor confidence, posing a substantial threat to market integrity. Moreover, there is no standard practice among municipal securities brokers, dealers, or advisers of verifying these claims.

As both a market participant and a policy institute that advocates for fair capital markets and transparency around ESG matters, CAP is responding to questions in Section E of the RFI. In this letter we maintain that climate change is indeed a systemic risk. We recommend that the MSRB require municipal securities brokers, dealers and advisors to disclose their processes for evaluating sustainability, climate-related risk, and other ESG factors in selecting investments, creating ESG-related funds, and offering investment advice, including whether their analysis is science-based and whether and how the issuer's representations have been verified.

In addition, we recommend that the MSRB consider changes to its EMMA platform to facilitate more transparency on these matters and make ESG-related information and documentation provided by issuers easier to locate.

Finally, we encourage the MSRB to work with the SEC to enhance disclosure rules for underwriters of municipal securities, specifically requiring them to obtain and review the issuer's statements about climate emissions and climate risk and secure the issuer's commitment to continuing disclosures on any climate statements or events.

Climate change poses a systemic risk to the capital markets

Climate change represents an existential threat to civilization, and many negative climatic changes are occurring faster than research had initially suggested, reducing the time remaining to avoid the very worst effects of a warming planet. This rapid and destabilizing change presents significant risks to the financial system and specifically the municipal bond market, which currently has more than $4 trillion in outstanding issuances.[1]

[1] Securities Industry and Financial Markets Association, "US Municipal Bond Statistics," available at https://www.sifma.org/resources/research/us-municipal-bonds-statistics/ (last accessed March 2022).

Individuals, or retail investors, directly or indirectly hold the overwhelming majority of municipal securities, and they often hold them until maturity. Thus, risks associated with these municipal securities may have widespread impacts in the economy. Municipal securities are particularly vulnerable to the physical risks of climate change. When climate disasters strike, the projects themselves may be damaged or destroyed, increasing costs of completing the project or delaying completion, which is probably necessary before revenues can be generated from the project. In some cases, the entire municipality may be destroyed, as occurred when fires destroyed the town of Paradise, California. In such situations, credit enhancements may not be adequate to make bond holders whole.

Yet, the climate-related risks faced by investors, including municipal securities investors, are not uniform. For instance, a low-lying coastal community that experiences frequent tropical storms and hurricanes and which is heavily dependent on sales and transitory occupancy taxes paid by tourists presents a different risk profile than an inland community with a diversified economic base. Unfortunately, issuer disclosures typically offer no detail beyond mentioning the existence of climate change. As a result, investors have no meaningful data to weigh the differential climate risks presented by various issuances. At a minimum, this lack of information decreases the likelihood that the municipal bond market is appropriately pricing climate risk. And, more concerning, it increases the likelihood that perhaps millions of investors will be harmed when a widespread climate disaster occurs.

Large-scale catastrophic damage to municipally-financed infrastructure from increasingly severe weather events is not a theoretical or uncertain concern, and there is data available for estimating the potential impacts. For instance, in 2017, Hurricanes Irma and Maria devastated the facilities of the Puerto Rico Aqueducts and Sewers Authority (PRASA). According to PRASA, the storms forced the suspension of meter reading for 60 days, causing a loss of $271 million in revenue.[2] PRASA also estimated that the incremental costs associated with storm response would be $396 million and include capital repairs of $769 million, for a total cost of $1.4 billion.[3] Unfortunately, the severe financial shock faced by PRASA is a harbinger of what is to come for other municipal issuers.

Acute financial shocks are not the only climate-related threat to municipal securities investors. Long-term structural cost increases due to climate change adaptation also present risks. For instance, the Miami-Dade Water and Sewer Department (WASD) operates as a separate enterprise unit of the county government. This means that WASD leverages its operating revenues to finance its capital program. Many of WASD's outstanding issuances extend out for twenty to thirty years. During this time, the Department will have to contend with rising costs associated with climate adaptation. Drinking water in South Florida comes from the Biscayne Aquifer, which is a shallow,

[2] Puerto Rico Aqueducts and Sewers Authority, "Revised Fiscal Plan to Incorporate Modifications to the Certified Fiscal Plan as a Result of the Impact of Hurricanes Irma and Maria" (San Juan: 2018), available at https://emma.msrb.org/ES1137216-ES889836-ES1291154.pdf.

[3] Ibid.

porous limestone formation highly vulnerable to saltwater intrusion and contamination. Both the pace and severity of sea level rise will affect the capital outlays WASD must make (and by extension the degree of leverage to its operating revenue stream) to maintain the viability of the Biscayne Aquifer. At some point, WASD may have to make capital-intensive outlays to secure potable water farther inland.

In managing their portfolios, investors typically view bonds as a reliable investment that provides lower but more stable returns. This is all the more reason why the quality of bond disclosures is essential, especially when it comes to climate risks. Yet, as the PRASA and WASD examples demonstrate, climate change very likely will saddle issuers with abrupt and unexpected costs and reduced revenues as well as escalating, structural cost challenges —both of which will threaten creditworthiness. The credit effects of these climate risks should not be simply relegated to post-issuance ongoing disclosures but rather incorporated into the original issuance to the greatest extent possible through quantitative sensitivity analysis covering a range of possible cost and revenue scenarios.[4]

While recognizing the limitations of the MSRB's authorities, CAP believes that the Board can take meaningful steps to improve transparency around climate change and other ESG risks associated with municipal securities.

Recommendations

The widespread practice of self-certification by municipal securities issuers and the practice of greenwashing raise serious concerns for investors. While some existing third-party frameworks for certifying green bonds are more science-based than others,[5] investors need consistency and comparability as well as reliability of disclosures in order to make investment decisions. The following measures could begin to provide investors with the information they need.

The MSRB should require municipal securities brokers, dealers, and advisors to develop and publicly disclose their procedures for verifying ESG claims related to municipal securities included in ESG-labeled funds or recommended for investors. The MSRB has authority to require municipal securities brokers, dealers and advisors to make disclosures and produce documents that provide "clear and concise information about investment objectives, strategies, costs, and risks."[6] Retail investors seeking to invest in companies that meet ESG-related goals rely on these intermediaries to reliably direct them to ESG companies and funds and have a right to know how their broker,

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[4] See, e.g., *Climate Change and Municipal Finance*, available at https://www.americanprogress.org/article/climate-change-municipal-finance/ and generally https://www.americanprogress.org/article/secs-time-act/.

[5] For a discussion of current green bond labeling, see *A Framework for Strengthening Municipal Market Green Bond Labeling*, available at https://www.americanprogress.org/article/framework-strengthening-municipal-market-green-bond-labeling/.

[6] Securities and Exchange Act of 1934, 15 U.S. Code Section 78o-n, available at https://www.law.cornell.edu/uscode/text/15/78o.

dealer or advisor selected the investments offered, including whether the ESG claims are science-based and whether the issuer's claims have been verified and by whom. This is particularly important since municipal securities are traded in a decentralized over-the-counter market that is illiquid and opaque. A relatively small number of brokers and dealers handle the majority of trading in municipal securities, so their role in protecting investors is critical. Moreover, ESG claims may affect pricing, so assessment of these claims is an essential aspect of brokers' and dealers' duty to exercise due diligence in establishing the market value of a municipal security.

Alternatively, or in addition, the MSRB should work with the SEC to amend Rule 15c2-12,[7] to require municipal securities underwriters to engage with issuers on critical climate-related matters. When issuers make statements regarding climate emissions, climate risk, or other ESG matters, underwriters should be required to review the issuer's statements and secure the issuer's commitment to provide continuing disclosures to investors on any climate-related statements or events.

The MSRB should update EMMA to make it easier for issuers to post more detailed and machine-readable disclosures around climate emissions, climate risk, and other ESG factors, as well as documents providing evidence of verification by third parties. This information should be easily located on the website and categorized or labeled in such a manner that viewers can more easily compare bond issues. In addition, the MSRB should work with the SEC as it develops climate disclosure and other ESG rules and make revisions to the format of the EMMA website that will encourage issuers to list information consistent with the SEC rules for corporate issuers.

Other helpful steps the MSRB could take include:

The MSRB should conduct research and educate municipal securities issuers, investors, market participants, and the public about climate emissions, climate-related risks, and other ESG factors, including how those factors can affect the value and resilience of municipal securities issuers and the underlying projects being funded.

Finally, the MSRB should publicly acknowledge that climate change poses a systemic risk to the U.S. municipal securities market.

Conclusion

As the incidence and severity of climate events accelerate, it is critical that the MSRB, working with the SEC, take steps to ensure that investors and other market participants have the information they need to protect their hard-earned savings from climate and other ESG risks. Actions like those recommended here will provide more transparency

[7] U.S. Code of Federal Regulations, 17 CFR Section 240.15c2-12, available at https://www.law.cornell.edu/cfr/text/17/240.15c2-12 (last accessed February 2022); and recent amendment at U.S. Securities and Exchange Commission, Amendments to Municipal Securities Disclosure, Release No. 34-83885, February 27, 2019, available at https://www.sec.gov/rules/final/2018/34-83885.pdf (last accessed February 2022).

and will enable investors to make informed decisions and invest with confidence. Over time, greater transparency around climate emissions and risk will also help move capital toward those municipal securities investments that are more resilient and in turn provide some protection against systemic risk to the financial system.

Sincerely,

Alexandra Thornton	Kevin DeGood
Senior Director, Tax Policy	Director, Infrastructure Policy