

## Community Finance Brief

### Overcoming Obstacles to Impact: Disclosure, Part 2



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Impact and disclosure go hand-in-hand. What are you doing and why are you doing it? When it comes to the public purse and regulated securities, there are legal issues to contend with that make the \$4 trillion U.S. municipal bond market distinct.

As discussed last week, municipal bond disclosure has the potential be transformative as it not only offers detailed information on a state or local government financial decision-making, but it could provide a broad outlook on how it intends to change the community it represents. With this said, the state of municipal bond disclosure has been under scrutiny since it was exempted from basic tenets of how disclosure works nearly five decades ago. In the wake of the 2008 financial crisis, municipal bond disclosures saw an increase in scrutiny with usually the Securities and Exchange Commission (SEC) looking at ways to change behaviors without changing the law. The desire for better information by Congress but also by impact-oriented investors and those concerned about ESG-related risks, has the potential to set new precedents that has many state and local governments (or at the least their trade associations) concerned.

#### **AN AMENDMENT TOWERS OVER THE MARKET**

Bond disclosure has one key caveat when it comes to U.S. state and local governments issuing municipal bonds: the markets principal regulator can't regulate them.

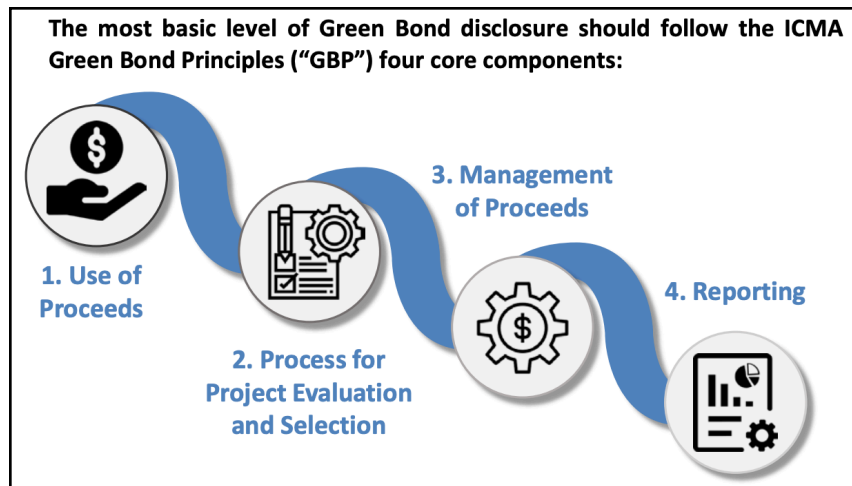
The Tower Amendment is a nearly 50-year old piece of legislation that amended the Securities Exchange Act of 1934 and it prohibits Federal regulators from requiring issuers of municipal bonds to file documents with regulators prior to sale. For anyone that follows capital markets with any degree, this likely seems well outside the norms of how

#### **Quick Takes**

Between 1975 and 2020 there have been a total of 729 defaults on municipal bonds issued in the United States with a total par amount defaulted being \$21.6 billion, well below 1% of all issuances and a fraction compared to any other publicly traded marketplace in the world (this does not include technical defaults)  
- *Securities and Exchange Commission*

The Tower Amendment was named after Senator John Tower of Texas, who introduced an Amendment to the Securities Exchange Act in 1975 that prevents many requirements of issuers of municipal bonds.

The International Capital Markets Association represent bond issues in over 100 countries and over \$50 USD trillion in debt with a general focus on infrastructure, education, healthcare and housing; it members are responsible for creating and maintaining standards and practices that govern international markets  
-*International Capital Markets Association*



regulated, open markets function in the modern world.

To be explicit: when a U.S. government sells a publicly-traded bond in the primary market, the SEC cannot force that government to disclose information about the sale. The regulator for the municipal bond market, the Municipal Securities Rulemaking Board (MSRB), also has no ability to enforce rules on state and local governments whatsoever and the SEC can only act against a municipal bond issuer if it is claiming fraud on behalf of a government issuer.

To summarize the reasoning behind this: it is constitutional (a check on federal overreach into state and local sovereignty), it is political (the market itself represents the federalist approach to American democracy), it is practical (the market is made up of thousands of very small borrowers that lack the ability and resources to meet corporate bond disclosure litmus) and it does not pose a risk (default rates are minuscule and diligence requires so-called sophisticated investors to participate in the marketplace).

As such, the reality of issuing debt in the municipal bond market is that governments offer an official statement when selling bonds in the primary market and while strongly encouraged to do so, are not legally required to offer continuing disclosure throughout the life of a bond. As one can imagine, with ascertaining material financial information of a bond not assumed, getting social or environmental implications of a project financed by municipal bonds creates an extra hurdle.

## MATERIALITY OF ESG RISK AT ISSUE

“Congress intentionally chose not to create a federal regulatory registration regime governing municipal issuers,” stated then-

**Securities and Exchange Commission**

**Chairman Jay Clayton**

in 2018 *written remarks*.

“Statutory provisions known as the Tower Amendment expressly limit the SEC’s and the MSRB’s authority to require municipal issuers to file any document with the SEC or MSRB prior to any sale of municipal securities by the issuer. Therefore, the Commission’s investor protection efforts in this market have focused primarily on the regulation of broker-dealers and municipal advisors, Commission interpretations, enforcement of the antifraud provisions of the federal securities laws, and oversight of the MSRB.”

Further exacerbating the problem of acquiring information about the social/environmental efficacy of municipal bonds is the concern that adding more information to a bond document that is outside of the norm implies that it is material and thus must be disclosed.

Between the lines: government bond issuers, most of which are fiercely in favor of Tower Amendment protections, must consider the implications of starting to include corollary, non-financial information in their disclosure documents. While impact investors are clamoring to see more of this, it could set a precedent that it should be mandatory. This 'slippery slope' argument is the primary driver behind state and local governments unwillingness to engage in producing more information in their bond offering documents.

Still, the arguments that climate volatility pose a material risk to a government's credit profile are strong. As per securities law, issuing entities have an obligation to publicly disclose information to prospective investors so that they can make informed investment decisions. In U.S. public finance, the issuing entities are unable to change their physical location like a corporation can. As such, changing environmental conditions, such as rising sea water or the increased amount of tornadoes for example, effect a government directly and may be considered material. With no consensus as to how the industry will move forward on whether or not climate change is material to an investment in a government, **CSG** expects this to be litigated. In the near future we expect an investor to sue a state or local government for not disclosing an environmental issue and it will end up being a judicial decision that sets a precedent on this topic going forward.

## WHEN POLITICS MATTER

The 'slippery slope' piece of this discussion is the third rail when it makes its way to Washington, D.C. where legislative action would be the means for repeal of Tower. Advocates for states and local governments have long made it clear that any discussions in regards to changes to the Tower Amendment are a non-starter. Historically, if a Congressperson makes a case for such action, their office is flooded with calls with the many government jurisdictions within their district or state that issue municipal bonds. As such, it is largely seen as a non-viable political avenue to pursue.

"So the goal of the FDTA is to make all of this data more accessible, more uniform, and more useful to the users out there who are trying to look at trends or collect data across maybe various issuers or various issues of bonds or multiple disclosures from the same issuer," stated **Kim Magrini, Ballard Spahr** at a May 2023 [SEC Conference](#). "I want to emphasize that the FDTA doesn't affect or change substance of disclosures or mandate the type of disclosure or what's in the disclosure, but it addresses the formatting of the disclosure. So you aren't going to see in this act any change in, you know, what you might have to submit under continuing disclosure agreement, for example. It's just related to how that data is standardized, collected, and tagged, for ease of use there."

And those advocates for protecting the Tower Amendment are not wrong. The municipal bond market is unlike any other in the world and posing corporate-like disclosure requirements would cause significant strain on smaller communities. The counterpoint to that is that perhaps these smaller communities should not be issuing bonds in the first place with such limited resources. To that, a final point in response would be the extremely low default rates for municipal bonds (see, **Quick Takes**, above).

The Financial Data Transparency Act (FDTA), which was passed last year, requires machine-readable financial disclosure and in general more standards in disclosure, has reinvigorated the disclosure debate. Advocates for state and local governments have made the case that, like a repeal of Tower, FDTA requires more resources than governments have to comply **see quote, right**).

FDTA has awoken the government issuer lobbying apparatus and, if nothing else, has promulgated many age old stances around municipal bonds and disclosure. To that end, it looks as though more efficacy in disclosure is less plausible.

We see this as short-sighted. FDTA offers an avenue within which much needed standards and technological advancements can begin to make their way into the municipal bond marketplace. Repeal of Tower is not needed when there are technological solutions in the making. ESG, impact, green or blue - whatever you want to call it - is the result of a zeitgeist that state and local governments could take advantage of. Transparency is in the interest of all community members.

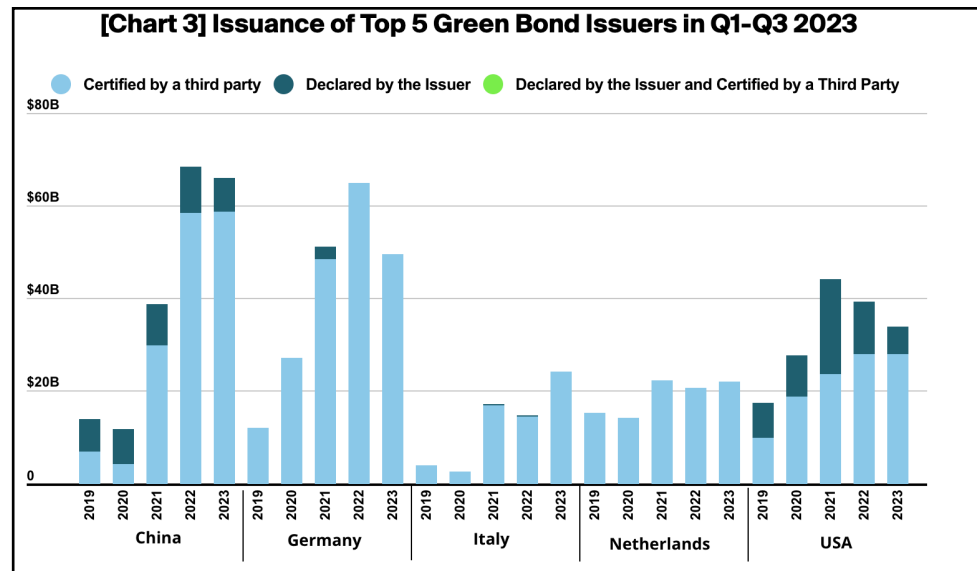
## **A PATH FORWARD**

The current context of materiality as discussed above has muddled the waters about what can and cannot be done. There is no legal barrier to states and local governments providing information outside of official disclosure that is *relevant* to the projects being financed. Absent a very unlikely legal requirement to engage on financial efficacy of government projects on the communities they serve, bond issuers should consider offering corollary, non-financial information to investors through means outside of the disclosure legal paradigm.

Leaders in this space have dedicated websites with quarterly or annual reports dedicated to impact and/or ESG issues such as the San Francisco Public Utilities Commission, the District of Columbia Water and Sewer Authority and New York State Environmental Development

*“This process has been driven by moneyed special interests not with the best interest of the muni space and the community and investors and analysts,” said Ben Watkins, director of bond finance for the State of Florida. “The conclusion that I come to is FDTA as a way to improve transparency and disclosure in the muni space is a ruse and structured data is not nirvana.”*

Corp., for example. This is a start but to date there are no standards or even broadly adapted frameworks within which information can be provided to add context. As a result, as ICE data demonstrates in the **chart** to the right, the U.S. is an outlier when it comes to impact



issuance and verification as there is a much higher percentage of self-reporting - this is not necessarily a good thing and is the result of what is still a nascent marketplace in this country.

Two points on the above, which are generally applicable to the rest of the country: it tends to be larger, urban areas of the country that are offering this type of information and, second, it is not information that is easy to digest. On the first point, rural and suburban areas that have many of the same problems are not providing the same level of information. On the second point, many of these so-called green programs are self-verified, meaning that they have their own internal processes so comparing programs to each other is nearly impossible. Further, the third-party verifiers eschew any responsibility for their labels, rendering them essentially useless to investors.

The Government Finance Officers Association, the largest advocate for state and local municipal bond issuers has a publicly available best practices on ESG while most recently, the California Green Bond Market Development Committee, released [a framework](#) on green guidelines for issuers in that state that was co-written by many large inventors of municipal bonds (**the figure on page 3** is taken from noted brochure). These efforts and others are rightly applauded by market observers but the industry is at a juncture where next steps should be taken and they should be taken by governments themselves as the investor universe is extremely fragmented and proprietary when it comes to their approaches.

It would behoove more governments to think about basic templates for what relevant information that is easily accessible could be positioned in line with their bond portfolios. Creating templates that are clearly separate from bond disclosure documents would mean a lot for progression when it comes to the public finance industry. Avoiding the materiality discussion and the Tower Amendment as obstacles to impact investors needs to be a broader discussion in the industry if it is to fully embrace the impact investing community. Offering more relevant information to government decisions is a win for community-oriented finance and for advocates of open government in general.