Bond Case Briefs

Municipal Finance Law Since 1971

The ABCs of ESG: Practical Considerations for Environmental, Social and Governance Disclosure in Municipal Finance.

In order to make an informed investment decision as to the purchase of municipal bonds, the latest trend is for investors to evaluate environmental, social and governance ("ESG") factors relative to the bond issuers in question, state and local governments.[1] In making this determination, investors primarily look to the information provided by the issuers in the offering document or official statement for the issuance of the bonds. As a result, in preparing their offering documents, issuers must now weigh the applicability, significance and scope of ESG factors with respect to their financial condition, operations and overall investor mix. In this blog, we will discuss ESG disclosure practices, review the benefits and risks of including such disclosure and contrast general ESG considerations with specific green bond issuances.

Currently, neither the Securities and Exchange Commission nor the Municipal Securities Rulemaking Board ("MSRB") has weighed in with regulatory guidance as to ESG disclosure in the municipal marketplace. Some industry participants have argued for a uniform set of criteria or a checklist for ESG disclosure, as a means of promoting clarity and consistency. However, questions remain as to whether a "one size fits all" approach would be feasible for issuers and meaningful to investors, given the diversity of issuers and credits in the municipal space. Others have advocated for a principles-based approach, with general guidelines that issuers can apply and adapt to their particular facts and circumstances. The Government Finance Officers Association ("GFOA") has taken the lead role in this regard, releasing best practices for ESG disclosures.

Generally, the GFOA's ESG best practices focus on two main principles: (1) identifying and, if possible, quantifying the material ESG risks or factors affecting the issuer of the municipal bonds, specifically as they affect the issuer's operations and financial position, including its credit quality and ability to repay the bonds, as well as its infrastructure and ongoing projects (including projects to be funded with the bond proceeds) and (2) the policy actions to be taken by the issuer to address those risks/factors. In that regard, the environmental component of ESG is intended to address matters such as climate change and resiliency, energy efficiency and renewable energy. The social component focuses on diversity and inclusion, equity and social justice issues affecting the long-term sustainability of a community, such as income disparities, housing affordability, access to quality healthcare and public education and internet access and affordability. The governance component touches on the particular government's organizational structures, decision-making processes, budgetary practices, transparency, risk mitigation (cybersecurity), legal framework for the issuance of debt, financial reporting requirements and pension and OPEB liabilities. In that respect, it is likely that issuers are already addressing most of the topics under the governance component in their offering documents. Nevertheless, the current focus on ESG factors represents an opportunity for issuers to consider this information in a new light.

As a practical matter, the majority of projects financed with the proceeds of municipal bonds are likely to already fall within at least one of the three ESG categories. Nevertheless, ESG disclosure is intended to go beyond the specific projects, providing investors with a broader window into the issuer's overall operations and creditworthiness, with an emphasis on these factors.

It is worth noting that, under two key antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act of 1933 and Rule 10b-5 of the Securities Exchange Act of 1934, issuers must avoid making misstatements or omissions of material facts (with respect to ESG matters or otherwise) to investors in connection with the issuance and sale of municipal bonds to the public. Therefore, without a clear pricing differential or market advantage to offset this corresponding regulatory scrutiny, issuers may be understandably weary of including any new ESG disclosure in their offering documents. Additionally, to comply with MSRB Rule 15c2-12, underwriters involved in certain offerings of municipal bonds must confirm that the issuer will provide investors (through a filing with the MSRB) with annual updates to the financial information and operating data included in the offering document. Issuers should carefully consider whether any new ESG disclosure included in the offering document would be picked up by this annual reporting requirement.

Like ESG disclosure, issuances of bonds with particular labels such as "green," "climate," "social" or "sustainable," where the proceeds are used to finance related projects, have increased in popularity during the past decade. Although the concepts have certain similarities, providing broad ESG disclosure about an issuer in an offering document does not necessarily transform the bond issue into green, climate, social or sustainable bonds. Likewise, providing specific project-related details in connection with an issuance of green, climate, social or sustainable bonds may capture some, but not necessarily all, of the ESG disclosure principles outlined above relative to the issuer. Stated differently, notwithstanding the potential for overlap, ESG disclosure focuses on the status of the issuer overall, whereas a labeled bond issue focuses on the use of the bond proceeds to finance a particular project or set of projects. Green bond disclosure guidance is currently under development by both the National Federation of Municipal Analysts and the GFOA in any event.

It appears that investor interest in ESG considerations will be with us for the foreseeable future. Issuers should work with their bond counsel, disclosure counsel, financial advisors and underwriters to develop a sensible approach to address this trend.

[1] For conduit issuers, attention should be paid to the issuer and the borrower when evaluating ESG factors.

Adler Pollock & Sheehan P.C.

October 29, 2021