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Municipal Bond Market Impact of the SEC's Mutual Fund ESG Proposals: Ballard Spahr

Summary

Two pending proposals could significantly affect how mutual and other funds approach their ESG investments in municipal bonds. If adopted by the Securities and Exchange Commission, the proposals could result in municipal issuers facing ESG-related expectations from mutual funds that are more stringent and less flexible as a precondition of accessing capital from segments of the fund industry that seek to serve the ESG-focused investor base.

The Upshot

- The Fund ESG Proposal would adopt specific disclosure requirements for funds regarding ESG strategies, including requiring some environmentally focused funds to disclose the greenhouse gas emissions associated with their portfolio investments. Municipal ESG holdings may need to conform to these new requirements.
- The Fund Names Proposal would amend existing SEC rules to, among other things, expand the current requirement for certain funds to invest at least 80 percent of their assets in accordance with the investment focus the fund's name suggests. The proposal raises questions on whether municipal bonds may sometimes be limited to the residual portion of fund assets if the name suggests an ESG focus.
- Some ESG-Focused Funds would be required to disclose the carbon footprints and weighted average carbon intensities of their portfolios, including their municipal holdings.

The Bottom Line

These pending SEC proposals on mutual funds may be the first new ESG rules that have a significant impact on the municipal market. While municipal issuers may conform their ESG practices to the proposed criteria for ESG fund holdings in structuring new offerings, they may face considerable obstacles applying the newer ESG practices to outstanding bonds that may be held by funds. In addition, issuers may need to choose between meeting heightened expectations or bypassing some ESG-Focused Funds as potential investors.
The municipal bond market is grappling with how best to approach evolving investor demand for environmental, social, and governance (ESG) disclosures and ESG-designated bonds under existing federal anti-fraud and materiality standards and through voluntary industry best practices. These conversations are happening against the backdrop of the Securities and Exchange Commission's (SEC) pending ESG regulatory proposals for the corporate securities1 and mutual fund2 markets. Many market participants look to these pending SEC proposals for clues to what regulators might have in store for the municipal market in the future.3

However, the pending Fund ESG Proposal and Fund Names Proposal could themselves result in significant and more immediate effects on how mutual and other funds – the second largest investor segment for municipal bonds4 – approach their ESG investments in municipal bonds. If adopted by the SEC, the proposals could result in municipal issuers facing a number of ESG-related expectations that are new, more stringent and/or less flexible than the current market as a precondition to continuing to access capital from the fund industry that seeks to serve the ESG-focused investor base. While municipal issuers may seek to conform their ESG practices to these criteria in structuring their new offerings going forward, they would face considerable obstacles in applying the newer ESG practices to outstanding bonds that may be held by funds.

Summary of Recent SEC Fund Proposals

In broad summary, the Fund ESG Proposal would apply to registered investment companies and business development companies (funds), as well as registered investment advisers and certain unregistered advisers (advisers). The Fund ESG Proposal would (i) require specific disclosure requirements regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures; (ii) implement a layered, tabular disclosure approach for ESG funds to allow investors to compare ESG funds at a glance; and (iii) generally require certain environmentally focused funds to disclose the greenhouse gas (GHG) emissions associated with their portfolio investments. In addition, the Fund Names Proposal would amend the SEC's existing fund names rule to (i) improve and expand the current requirement for certain funds to adopt a policy to invest at least 80 percent of their assets in accordance with the investment focus the fund's name suggests; (ii) provide new enhanced disclosure and reporting requirements; and (iii) update the rule's current notice requirements and establish recordkeeping requirements. The provisions of these proposals that are potentially relevant to municipal securities issuers are described below.

Potential Impact of SEC Fund Proposals on Municipal Securities Issuers

Some of the new ESG-related expectations incorporated into the Fund ESG Proposal and Fund Names Proposal, and their potential impacts on municipal issuers, include the following:5

- More Structured Criteria for Consideration of ESG Factors When Making Investment Decisions – For any funds that consider one or more ESG factors in their investment decisions – whether along with other non-ESG factors, with the ESG factors being no more significant than other non-ESG factors (Integration Funds), or as a significant or main consideration in selecting investments (ESG-Focused Funds) – the funds may need to establish more structured criteria than they currently use on how they incorporate ESG factors into the investment selection process, including what factors they consider.
- Municipal issuers may experience less flexibility from funds on how they apply ESG factors in assessing a potential investment in their bonds given funds' need to comply with their publicly disclosed more structured investment criteria.
- Heightened ESG Investment Criteria for ESG-Focused Funds – In the case of ESG-Focused Funds, the fund proposals would require more detailed criteria for considering ESG factors in making investment decisions, including descriptions of any methods for including or excluding investments (such as any quantitative thresholds or qualitative factors used), any scoring methodologies, methods for evaluating the quality of third-party data used, and the use of any third-party ESG framework (including how funds determine that a portfolio holding is consistent with the framework).

- Municipal issuers may experience heightened expectations from ESG-Focused Funds with respect to the information (potentially including quantitative information) issuers would need to make available concerning applicable ESG factors so that such funds can maintain investment portfolios that are consistent with disclosed criteria. As a result, issuers may need to choose between meeting these expectations or bypassing some ESG-Focused Funds as potential investors.
- In addition, ESG-Focused Funds with names suggesting that investment decisions incorporate one

or more ESG factors must meet an investment policy requirement that at least 80 percent of the value of assets in the funds' portfolios consist of the type of investment suggested by their names. It is unclear if municipal bonds that have ESG characteristics but may not meet the formal criteria of a particular ESG-Focused Fund might still be considered within the 80 percent investment policy requirement or would otherwise be limited to the remaining more-flexible portion of the fund's portfolio holdings. If so limited, the level of investor interest in such bonds may be significantly reduced.

- Additional Disclosures for Impact Funds – For ESG-Focused Funds that select investments that seek to achieve one or more specific ESG impacts (Impact Funds), in addition to the requirements described above for ESG-Focused Funds, such Impact Funds would be required to disclose the impacts they are seeking to achieve, how they seek to achieve such impacts, how they measure progress toward the specific impacts (including key performance indicators), the time horizons used to analyze progress, and the relationship between the impacts sought and financial return.
- Municipal issuers seeking investments from Impact Funds would in most cases need to be willing and able to provide ongoing qualitative and/or quantitative data on the achievement of specific goals or similar measures of progress toward the applicable impact. Municipal issuers may need to choose between providing this ongoing information or bypassing Impact Funds as potential investors.
- Methodology When Considering Greenhouse Gas (GHG) Emissions – For Integration Funds that consider GHG emissions of their holdings as one ESG factor in their investment selection process, the funds would be required to describe the methodology used for considering portfolio investment GHG emissions.
- Municipal issuers may need to consider what, if any, information they may be willing and able to generate and disclose with respect to their GHG emissions in light of the various methodologies different Integration Funds may develop. No particular methodology is mandated, nor would Integration Funds be required to use quantitative metrics; however, funds that consider GHG emissions likely would develop more structured criteria for doing so (which may include quantitative measures) and, as a result, may have less flexibility in how they assess GHG emissions tied to a particular investment in a municipal bond for their portfolio in light of these criteria. Municipal issuers may need to choose between meeting such methodologies or bypassing some Integration Funds requiring GHG emissions information as potential investors.
- Quantitative Disclosures of GHG Emissions for Some ESG-Focused Funds – Unless ESG-Focused Funds that consider environmental factors affirmatively disclose that they do not consider issuers' GHG emissions as part of their investment strategy, these ESG-Focused Funds would be required to disclose the carbon footprints and weighted average carbon intensities (WACI) of their portfolios. Calculation at the fund-level of carbon footprint and WACI would require quantitative measurements of each portfolio security issuer's enterprise value, total revenues and Scope 1 and Scope 2 GHG emissions.6 While such funds would be required to use GHG emission data produced by issuers of portfolio investments if available, they would be permitted to use good faith estimates based on publicly disclosed methods of estimation of the portfolio issuer's Scope 1 and Scope 2 emissions if no such issuer-produced data were available.
- Municipal issuers seeking investments from ESG-Focused Funds that consider GHG emissions would in most cases need to be willing and able to provide significant quantitative data of the type required by the proposal. It is unclear whether such funds would be willing to make good faith estimates for issuers that do not produce the required GHG emissions data. Municipal issuers may need to choose between undertaking to provide requisite GHG emissions data or bypassing ESG-Focused Funds that consider GHG emissions.

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[1] "The Enhancement and Standardization of Climate-Related Disclosures for Investors," Securities

Act Release No. 11061 (March 21, 2022).

[2] "Investment Company Names," Securities Act Release No. 11067 (May 25, 2022) (the Fund Names Proposal), and "Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies," Securities Act Release No. 11068 (May 25, 2022) (the Fund ESG Proposal).

[3] The Municipal Securities Rulemaking Board (MSRB) also published MSRB Notice 2021-17 (December 8, 2021) requesting information on ESG practices in the municipal securities market, which generated 52 letters from an array of market participants. Commenters on balance expressed the view that substantive ESG-related regulation with respect to municipal securities, if any, should most appropriately be undertaken by the SEC rather than the MSRB, with the MSRB potentially making certain enhancements to its Electronic Municipal Market Access (EMMA) system to support more efficient and effective dissemination of any ESG-related disclosures.

[4] As of the end of the second quarter of 2022, mutual funds (including money market and closed-end funds) held $1.02 trillion out of the outstanding $4.04 trillion of municipal securities, constituting approximately 25.3 percent of the municipal securities market. Board of Governors of the Federal Reserve, Z.1 Financial Accounts of the United States – Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts – Second Quarter 2022 (September 9, 2022), Table L.212. Only the household sector held more, with approximately $1.61 trillion.

[5] These proposals include a number of other provisions not described herein, and readers should refer to the applicable SEC releases for completes description of each proposal. In addition, the Fund ESG Proposal includes provisions applicable to advisers that may have an impact on their ESG-related investment decisions on behalf of their separately-managed accounts and other clients.

[6] Funds would only be required to disclose Scope 3 GHG emissions of any portfolio issuer that itself discloses Scope 3 emissions.

September 19, 2022

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