MSRB
Municipal Securities Rulemaking Board

November 17, 2023

Cristina Martin Firvida
Director
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 2023

Dear Ms. Martin Firvida:

The Municipal Securities Rulemaking Board (MSRB) appreciates the opportunity to respond to the Securities and Exchange Commission's (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 2023. 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 advances 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) deeply discounted bonds; (2) growth in separately managed accounts; and (3) climate risk disclosures.

Deeply Discounted Bonds

The potential risk associated with deeply discounted bonds is carried over from the MSRB's 2022 letter to the SEC Investor Advocate. In 2023, we have seen a continued rise in interest rates that started in 2022. In fact, tax-exempt benchmark interest rates have risen to levels not seen since 2007. With the significant rise in interest rates over the past two years, there has been a dramatic rise in tax-exempt municipal bonds purchased by investors in the secondary market at a significant discount to par, also known as a "market discount." Although purchasing bonds at a market discount can be a logical part of a portfolio strategy, individual investors must be aware that this practice could result in significant tax implications. Internal Revenue Service rules determine whether the price appreciation (or accretion) of a bond that is purchased at a discount will be taxed at the individual's ordinary income tax rate, or if it will be taxed at the capital gains tax rate.

Generally, if the discount to par 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. However, if the discount is greater than this *de minimis* threshold, the accrued market discount realized at maturity must be treated as ordinary income.

Unless rates decline dramatically in 2024, the MSRB expects the number of bonds purchased at a discount to remain at elevated levels compared to pre-2022 levels. As a result, investors will continue to be more likely to transact in bonds that will have a different market discount tax treatment than in a period of lower interest rates. 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 deeply discounted bonds.

Investors also should be mindful that bonds with a 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 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 for the bond compared to bonds trading at par or at a premium because of the tax consequences associated with buying the bond. This risk could negatively impact the price the investor would receive for the bond.

In 2016, the MSRB reminded dealers of their obligation to disclose to their customers, at or prior to the time of a transaction in municipal bonds, the fact that a municipal security bears a market discount that may significantly affect its tax treatment.[1] As interest rates rose throughout 2022, the MSRB published an educational resource, which it recently updated, that focuses on the potential impact to investors of the current market environment on bond prices and the tax and liquidity implications of buying discount bonds in the secondary market. [2]

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[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).

Separately Managed Accounts

Based upon independent research provided by third parties as well as conversations the MSRB has had with market participants, it is apparent that the use of separately managed accounts (SMAs) for municipal bonds continues to grow significantly. SMAs are custom investment portfolios owned by an investor and managed by a professional money manager who has full discretion to execute trades. Like traditional investment advisory services, fees for SMAs are based on a percentage of the assets under management. SMAs represent one of a number of ways individual investors can invest in municipal bonds. Other options include traditional brokerage accounts (not fee-based), mutual funds and exchange traded funds (ETFs).

The MSRB highlighted the characteristics of these various options in an investor education publication titled "Ways to Buy Municipal Bonds." Given the significant growth of SMAs in the industry, the MSRB has some concerns that individual investors may not have a complete understanding of the potential differences in portfolio construction, investing strategies and costs across the different ways to purchase municipal securities.

Issuer Disclosure Practices

With the exception of the anti-fraud provisions of federal securities law, the SEC has no direct authority over issuers of municipal securities to require that they provide disclosures regarding their municipal securities offerings. The MSRB also has no direct authority over issuers and the content of their disclosures and is further constrained by the Securities Exchange Act's Tower Amendment from requiring an issuer, directly or indirectly through a broker-dealer or municipal advisor, to furnish to the MSRB or to an investor any such disclosure document unless it has become generally available.

Within its limited rulemaking authority under the federal anti-fraud provisions, the SEC's Rule 15c2-12 obligates broker-dealers, in their capacity as underwriters, to obtain and review an issuer's disclosure document, commonly known as an Official Statement ("OS"), for most new issues of municipal securities. Unlike in other markets, the SEC does not mandate specific items of information that an OS must include, although the federal anti-fraud provisions prohibit such OS from including any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. The MSRB, through its Electronic Municipal Market Access (EMMA) website, serves as a free public repository for OSs provided by municipal issuers to underwriters, which are required under MSRB rules to submit such documents to EMMA, but the MSRB has no authority to regulate the content of the disclosures themselves.

Climate risk disclosure is an ongoing topic of SEC rulemaking, including the SEC's pending rule proposals with respect to the enhancement and standardization of climate-related disclosures made by public companies (March 21, 2022) and enhanced disclosures made by certain investment advisers and investment companies about environmental, social, and governance investment practices (May 25, 2022). These proposals, if adopted, would not apply to issuers of municipal securities.

While the MSRB, as noted above, has no authority to establish requirements with respect to climate risk disclosures made by issuers of municipal securities, the MSRB published a request for information in 2021 inviting feedback on climate risk disclosures and related practices in the municipal securities market.[3] The MSRB received responses from a broad cross-section of viewpoints representing issuers, investors, regulated entities and other market participants. Among the many themes touched on by commenters, some expressed concern – which the MSRB shares – that the lack of standards and uniformity in climate disclosures made by issuers could be confusing for individual investors. The MSRB believes that inconsistent disclosure practices in general and climate risk disclosure practices in particular raise potential risks to investors in the municipal securities market.

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 if the MSRB can be of any further assistance.

Sincerely,

Mark Kim
Chief Executive Officer

CC: Marc Oorloff Sharma
Assistant Director and Chief Counsel
Office of the Investor Advocate
Securities and Exchange Commission

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[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.