

# Municipal Securities Regulation & Enforcement

## 2022 MID-YEAR REVIEW

The municipal securities market slowed during the first half of 2022 due to a variety of reasons including rising interest rates, reduced institutional demand resulting from municipal bond fund outflows, inflation and recession fears, and international tensions. Meanwhile, environmental, social, and governance (ESG) bonds remained a hot municipal market topic, with ESG factors and objectives continuing to draw the curiosity and interest of municipal securities issuers, investors, and regulators. On the enforcement front, the Securities and Exchange Commission (SEC) filed its first enforcement action alleging violations of Regulation Best Interest (Reg BI), as well as a series of disclosure-related actions in connection with municipal bond offerings.

The pace of issuance in the first half of 2022 has slowed from the breakneck pace of 2021 and 2020. Through June 2022, only \$208.2 billion of debt had been issued, which is a nearly 12 percent decrease over the same time period in 2021. This slowdown is attributable to a variety of factors including rising interest rates, which make refundings for interest rate savings less feasible; reduced institutional demand resulting from municipal bond fund outflows; inflation and recession fears and international tensions; declines in taxable bond issuance; and overall market volatility.

In June 2022, the Securities and Exchange Commission (SEC) brought its first action for alleged violations of Regulation Best Interest (Reg BI). SEC Commissioner Allison Herren Lee stated in a November 2021 speech that “the Commission intends to work, both directly and together with FINRA and others, to ensure that Reg BI lives up to its name; that is, to ensure that investors receive not merely *suitable* recommendations, but recommendations that are truly in their *best interest*.” The SEC enforcement actions during the first half of 2022 also highlighted the SEC’s continued focus on personal liability of municipal officials in actions for disclosure-related securities law violations.

During the first half of 2022, the MSRB proposed extending temporary pandemic-related measures and applying Reg BI to bank dealers, on par with similar broker-dealer regulations already in place.

Environmental, social, and governance (ESG) disclosures, both as they relate to designation of bond issues and risks, remain a hot topic for issuers, investors, and regulators as the municipal securities market continues to seek guidance and clarity. The MSRB’s response to the comments received this spring to its request for information on ESG best practices is still forthcoming and will be closely scrutinized for any hints towards future action by the MSRB in this area. While most market participants believe that

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any significant potential rulemaking having an impact on issuer ESG practices would likely be undertaken by the SEC, the MSRB could consider rulemaking or guidance on any related duties of broker-dealers or municipal advisors, and also could make enhancements to its Electronic Municipal Market Access (EMMA) website to assist issuers to more effectively disseminate ESG-related disclosures. The rapid growth of the ESG space in the municipal market has also begun to generate pushback from certain elected officials that are critical of the use of ESG-based metrics in the ratings process. We expect ESG will continue to remain a market focus as municipal market participants work towards establishing cohesive best practices and consensus on the form and content of disclosure in the primary and secondary market.

## **Enforcement Actions – Mid-Year Review**

### ***SEC Charges School District with Fraud and CPA With Professional Misconduct Related to Alleged False Reporting of General Fund Reserves***

On March 16, 2022, the SEC charged a public school district and its former chief financial officer with concealing the financial distress of the district in a 2018 municipal bond offering. The SEC alleged that the district's audited financial statements included in the district's 2018 official statement falsely reported the reserves in the district's general fund in an effort to conceal the district's declining financial health.

The SEC alleged that, in 2016, after the district prematurely exhausted its 2013 bond proceeds, the district changed its fiscal year-end date from August 31 to June 30 and issued new municipal bonds, partially to increase general fund reserves to pay for the 2013 bond-funded construction projects that were still unfinished.

According to the SEC, the district's fiscal year 2017 financial statements understated construction expenses by \$7.9 million and payroll expenses by \$3.8 million. The SEC alleged these false financial statements were included as part of the official statement for the district's 2018 bonds. The district's financial troubles led to a declaration of financial exigency, resulting in the appointment of a monitor to oversee the district's finances and its efforts to achieve solvency. Ratings agencies also downgraded the district's bonds.

Without admitting or denying the findings, the district consented to a cease-and-desist order prohibiting future violations of federal securities laws. A copy of the order can be found [here](#).

In a related action, the SEC charged the school district's former auditor, a certified public accountant, with engaging in improper professional conduct.

The SEC alleged that the auditor knew about the district changing its fiscal year-end date and issuing additional bonds to address financial issues. According to the SEC, these circumstances required a heightened level of professional judgment and skepticism, which the auditor failed to display.

The SEC also alleged the auditor failed to follow generally accepted auditing standards, which require auditors to design and perform appropriate procedures to supervise the audit and obtain sufficient evidence to support the audit opinion. During fiscal year 2017, the auditor did not verify the district's construction and payroll liabilities.

Without admitting or denying the SEC's findings, the auditor agreed to sanctions. A copy of the order can be found [here](#).

### ***SEC Fines Broker-Dealer for Failing to File SAR Reports***

On May 20, 2022, the SEC charged a broker-dealer and investment advisor with failing to file certain suspicious activity reports (SARs) between April 2017 and October 2021.

Regulations promulgated under the Bank Secrecy Act (BSA) and the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) mandate that broker-dealers must file SARs with FinCEN. For certain suspicious transactions—or patterns thereof—involving a broker-dealer and at least \$5,000 in assets, a SAR report must be filed within 30 calendar days of classifying the activity as "suspicious." Suspicious activity includes transactions related to illegal activity, designed to evade BSA requirements, or without lawful purpose. To report continuing activity of a previously-filed SAR, the deadline is 120 calendar days after the previous filing.

In 2017, the broker-dealer had been charged with violating Section 17(a) of the Securities Act of 1933, as amended (the Securities Act) by failing to timely file at least 50

SARs. In 2019, the broker-dealer switched to a new anti-money laundering (AML) transaction monitoring system. According to the SEC, the new system failed to issue alerts for wire transfers involving multiple high-risk and moderate-risk countries and the broker-dealer failed to sufficiently perform testing or conduct post-monitoring implementation that would have allowed it to notice the flaws in the new system. After a request from the Financial Industry Regulatory Authority (FINRA), the broker-dealer identified the failures with the new AML system and worked to remedy them. The SEC alleged the broker-dealer filed at least 25 SARs based on the failed alerts, and these were filed an average of 157 days late.

Additionally, according to the SEC, from April 2017 to May 2019, certain wire transfer data was not appropriately processed in the broker-dealer's AML transaction monitoring system. The SEC alleged that this resulted in the system failing to generate about 650 alerts. After discovering the problem, the broker-dealer reviewed the missed alerts and filed at least nine additional SARs, between 546 and 1,209 days late.

Once the reporting issues were recognized, the broker-dealer engaged in a number of remedial efforts, including adding processes to timely identify and review missing wire data, plan AML system upgrades, and retain an outside consulting firm. Without admitting or denying the findings, the broker-dealer consented to a cease-and-desist order, and agreed to pay a civil penalty of \$7,000,000. A copy of the order can be found [here](#).

### ***SEC Charges Town With Fraud Related to Alleged Overstated Revenue Projections***

On June 2, 2022, the SEC charged a town, its former mayor, and its municipal advisor with including false projections regarding the anticipated revenue of the town's sewer system in state-mandated applications to approve the town's 2017 and 2018 municipal bond offerings. The SEC alleged the town's municipal advisor created the inaccurate projections with the participation and approval of the former mayor. The SEC further alleged the town failed to disclose prior misuse of bond proceeds to investors.

The SEC alleged that, in the town's applications to the bond commission, the town overstated the number of its sewer system customers and "backed into" revenue

projections that would be sufficient to meet a debt service coverage ratio of at least 1.0x. According to the SEC, the bond commission was unaware of the false projections. The SEC alleged that the town represented to investors in the 2017 and 2018 bonds that the bonds had been approved by the bond commission without disclosing that the approval had been based on intentionally overstated projections, thereby creating risk that the bonds may not be validly issued.

The SEC also alleged that proceeds from recent bond offerings were used for purposes contrary to the purposes stated in the offering documents, such as for police cars and the former mayor's payroll. The SEC stated that such a disclosure was required in the 2017 and 2018 offerings because the "Town's prior misuse of proceeds presented a risk that the Town would misuse proceeds in the 2017 and 2018 Bonds."

Without admitting or denying the findings, the town consented to a cease-and-desist order prohibiting it from future violations of federal securities laws. The town also engaged in remedial efforts, including improvements to its internal controls and establishment of a financial oversight committee tasked with approving any borrowing, applications for funds, or disbursements. A copy of the order can be found [here](#).

In addition to fraud, the SEC also charged the town's municipal advisor and its sole owner and employee with failing to register as municipal advisors and with violating fiduciary duty and fair dealing rules. Without admitting or denying the SEC findings, the municipal advisor and its owner agreed to consent judgments enjoining them from future securities law violations and agreed to pay disgorgement, prejudgment interest, and civil penalties in amounts to be determined at a later date by the court.

The town's former mayor chose to litigate the charges and the case is ongoing. A copy of the complaint can be found [here](#).

### ***SEC Charges City With Fraud Related to Alleged Undisclosed Overspending***

On June 14, 2022, the SEC charged a city, its former finance director, and the former chief financial officer of a school district with misleading investors who purchased

\$119 million in municipal bonds issued by the city on behalf of the city's school district. Additionally, the SEC charged the city's municipal advisor and certain principals thereof with misleading investors and breaching their fiduciary duty to the city.

According to the SEC's complaints, in August 2019, the city sold its bonds to provide financing for its school district, including cash flow financing for the school district for fiscal year 2020. However, the preliminary official statement and official statement provided to investors in connection with the bond issuance included outdated financial statements for the school district and did not disclose that the school district was experiencing imminent financial distress related to overspending on teacher salaries.

The SEC alleges the former school district CFO was aware that the school district was facing a budget shortfall of at least \$25 million, but misled a rating agency to the extent of the expected shortfall. The SEC also alleged in its complaints that the city's former finance director and principals of the municipal advisor were aware of the school district's financial distress, but did not inquire further about the school district's financial condition before the bond offering or inform investors of the related risks of the overspending to the school district's ability to repay the bonds.

In September 2019, approximately 45 days after the bond offering, the school district's auditors revealed that the school district had overspent its budget by nearly \$30 million. This announcement led to (i) a downgrade of the city's debt rating, (ii) the intervention from the State of New York in the form of a \$35 million loan to the school district in May 2020, and (iii) the appointment of a monitor to oversee the school district for a three-year period.

The SEC also alleged that the municipal advisor and its principals failed to disclose to nearly 200 municipal clients that the municipal advisor had material conflicts of interest arising from its compensation agreements.

The former school district CFO agreed to settle with the SEC, without admitting or denying the findings, and to be enjoined from participating in any future municipal securities offerings, in addition to paying a \$25,000 penalty. Litigation against the city, the former finance director, and the municipal advisors and its principals is ongoing. The SEC's complaints can be found [here](#) and [here](#).

### ***SEC Charges Investment Advisor and Representatives With Violating Reg BI***

On June 15, 2022, the SEC filed a complaint against an investment advisor and broker-dealer, as well as its registered representatives, for failing to comply with Reg BI, which requires broker-dealers to act in the best interest of retail customers when recommending any securities transaction.

Reg BI's "care obligation" requires broker-dealers to exercise reasonable diligence, care, and skill when recommending securities transactions to retail customers. Broker-dealers must understand the potential risks, rewards, and costs associated with the recommendation. They also must have a reasonable basis for believing that their recommendation is in the best interest of the particular retail customer. The compliance obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.

According to the SEC, the defendants recommended and sold approximately \$13.3 million in corporate L Bonds. L Bonds, a type of corporate bond sold to retail customers, are a high-risk, illiquid investment. These bonds are most appropriate for customers willing to accept a substantial degree of risk, interested in speculative investing, with substantial financial resources, and without a need for liquidity. The SEC alleged that the broker-dealer violated the care obligation by selling L Bonds without adequately understanding the risks associated with the investment.

The SEC alleges the registered representatives of the broker-dealer recommended L Bonds to at least seven retail customers without a reasonable basis for believing the investments were in the customers' best interests. These customers generally had a moderate to conservative risk tolerance, were not interested in speculative investments, lacked financial resources, and had a limited knowledge of investments and bonds. The SEC alleges the defendants' rationales for giving those customers L Bonds were unreasonable, vague, generic, and/or based on erroneous presumptions. At times, according to the SEC, defendants failed to notice the discrepancies between information on the forms and information recorded elsewhere.

The SEC also alleges that the broker-dealer breached Reg BI's compliance obligation by not adopting adequate compliance policies and procedures.

The SEC requests that defendants be enjoined from engaging in the acts, practices, and courses of business outlined in the complaint, as well as any similar ones. The prayer for relief also includes payment of disgorgement, prejudgment interest, and civil penalties. A copy of the complaint can be found [here](#).

### ***SEC Charges Former City Official for Falsifying Documents***

On June 16, 2022, the SEC charged a former city official with creating and distributing false financial documents related to securities offerings in order to hide his prior embezzlement of city funds.

In 2012 and 2015, the city issued and sold municipal securities. In connection with the issuance, the city entered into a continuing disclosure agreement. The city official was tasked with overseeing the annual audit, including coordinating with an independent auditor and providing the auditor with the requisite information to complete the audit.

The SEC alleged that the city official embezzled funds between 2015 and 2020. According to the SEC, the city official stole over \$1 million dollars in small amounts of between \$500 and \$10,000 and used these funds for his personal living expenses.

According to the SEC, there was a delay initiating the 2016 financial audit in order to cover up the embezzlement. The city official avoided contacting the auditor, while telling the mayor and others that he was waiting on necessary information. The EMMA submission deadline passed without an audit. In 2018, a rating agency withdrew its rating of the city's securities after failing to receive information about the 2016 audit. Finally, in 2018, after repeated requests, the city official provided falsified documents.

These falsified documents included an auditor's report and financial statements. The city official created the falsified documents by making revisions to the corresponding 2015 internally prepared financial information. The information did not reflect the funds

the official had embezzled and inaccurately stated that a suitable audit had taken place, when no audit had actually been completed.

The city official sent the financial statements to the mayor and municipal advisor, who distributed them to the public. The mayor posted them to the city's public website, and the municipal advisor uploaded them to EMMA. These documents were available for about ten months, during which time investors engaged in secondary trading in the city's outstanding municipal bonds.

The city official was criminally charged and entered into a plea agreement with the U.S. Attorney's Office, pleading guilty to one count of theft from a state or local government.

Without admitting or denying the findings, the city official agreed to be enjoined from future securities law violations and is also barred from future actions related to the sale of municipal securities, including participating in the issuance thereof, and preparing documents for EMMA. Additionally, the city official agreed to pay disgorgement, prejudgment, and civil penalties. A copy of the order can be found [here](#).

## **MSRB Rulemaking – Mid-Year Review**

### ***MSRB Proposes Extending Timeframe for Remote Office Inspections***

During the MSRB's quarterly meeting on January 26-27, 2022, the MSRB voted to propose amending MSRB Rule G-27 (on supervision) to extend the temporary ability for dealer firms to conduct office inspections remotely until December 31, 2022. The MSRB previously had provided this regulatory relief for the calendar years 2020, 2021, and through June 30, 2022, in response to the COVID-19 pandemic and continued prevalence of remote work throughout the industry. The proposed rule change was filed with the SEC on March 1, 2022, and became effective May 2, 2022.

### ***MSRB Proposes Extending Regulation Best Interest Obligations to Bank Dealers***

In 2019, the SEC adopted Reg BI, which set a new standard of conduct for broker-dealers when making a recommendation to retail customers of securities transaction or investments involving securities. Retail

customers are those that use recommendations primarily for personal, family, or household purposes. Reg BI provided that broker-dealers are obligated to act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interests of the broker dealer ahead of the interest of the retail customer.

As drafted, Reg BI did not apply to municipal recommendations to retail customers made by bank dealers, which led to a potential for disparate treatment of retail customers by bank dealers compared to broker-dealer recommendations.

On April 29, 2022, the MSRB filed a proposed rule change with the SEC to amend MSRB Rule G-19 on suitability of recommendations in order to require bank dealers to comply with Regulation Best Interest to the same extent as broker-dealers when making municipal securities recommendations to retail customers. If approved by the SEC, the proposed rule change would impose the Disclosure Obligation, Care Obligation, Conflict-of-Interest Obligation and Compliance Obligation under Regulation Best Interest on bank dealers. The SEC published a notice to solicit comments on the Reg BI on May 4, 2022, the full text of which is available [here](#). The SEC approved the rule changes on June 23, 2022. The approval order can be found [here](#).

## Litigation Updates

### ***Litigation Update – Case Closed Against Harvey, Illinois***

On January 13, 2021, a federal judge ordered the City of Harvey, Illinois, to rehire a consultant and prove the status of management reforms the city agreed to in a 2014 consent judgment that settled charges that the Chicago suburb fraudulently used bond proceeds. The SEC brought the city back into court in October 2020, and asked the city to fully implement recommendations laid out by an independent consultant aimed at bolstering the “city’s weak and ineffective system of internal controls.” A March 2019 report by the independent consultant concluded the “internal control environment within the city is still unreliable and informal and most likely will remain so unless forced by external regulatory bodies or a renewed commitment by the new administration to remediate undocumented

controls and policies and procedures as a top priority in 2019.” You can read more about that agreement and the city’s alleged violations in our 2020 Year-End Newsletter, found [here](#). On January 13, 2021, the U.S. District Court for the Northern District of Illinois, Eastern Division, found that the city violated the 2014 consent judgment and granted the SEC’s motion to enforce the consent judgment.

In January 2022, an additional report of the independent consultant was filed, noting that the city’s internal control environment had significantly improved to “Standardized.” The independent consultant concluded that, although the internal control environment of the city had improved, “[e]ffective ‘design’ does not, on its own, translate to ‘operating effectiveness’ of internal controls.” The independent consultant noted that the city would need to “provide the tone at the top, staff commitment and directing the necessary resources to build monitoring activities that include, but not limited to periodic testing, evaluation, and reporting to management regarding the compliance with such policies and control activities, as well as improvement opportunities to mirror best practices.” The SEC’s case against the city was closed in January 2022.

## ESG-Related Developments

### ***Next Steps for MSRB Relating to ESG Practices***

As discussed in our [2021 Year-End Report](#), on December 8, 2021, the MSRB issued a request for information on ESG practices in the municipal securities market. The deadline for the comments was March 8, 2022, and the MSRB received 52 submissions from issuers, individuals, and industry groups. On April 29, 2022, the MSRB announced that its next steps with respect to ESG practices in the municipal securities market would be to prepare and publish a summary of the comments and to host a series of virtual town halls to explore themes raised by the commenters. At the 116th annual meeting of the Government Finance Officers Association (GFOA) on June 5, 2022, Carol [Kostik](#), a public member of the MSRB’s board of directors and chair of the Audit and Risk Committees of the MSRB, announced that the comprehensive summary of the comments would be released in July 2022. Kostik additionally noted that “We don’t know what the next step is, it’s a learning process and this is the first step in the learning process. We’re not looking to lead with a regulatory foot.” As of the

publication of this newsletter, the comment summary has not been released and the virtual town halls have not been scheduled. Our August 19, 2021, municipal securities [white paper](#) entitled “ESG Disclosure in Municipal Offerings,” as part of our Municipal Securities Disclosure Series, discussed many considerations related to ESG-labeled bonds and related disclosure.

### ***SEC Activities in Connection With ESG Practices***

The SEC has not yet taken regulatory action on ESG in the municipal securities market. However, the [SEC proposed on March 21, 2022](#), amendments to the Securities Act of 1933 and Securities Exchange Act of 1934 that would require corporate issuers to provide certain climate-related information in their registration statements and annual reports. Such disclosures would include information about the issuer’s climate-related risks reasonably likely to have a material impact on its business, results of operations, or financial condition; disclosure of the issuer’s greenhouse gas (GHG) emissions, including so-called Scope 1 and Scope 2 emissions, as well as Scope 3<sup>i</sup> emissions if those emissions are material or if the issuer has set a GHG emissions reduction target or goal that includes its Scope 3 emissions; and inclusion of certain climate-related financial metrics in the issuer’s audited financial statements. The SEC has received over 10,000 comments on the proposal. While not applicable to municipal issuers, the proposal could be suggestive of some aspects of any rulemaking or guidance the SEC could pursue if it were to attempt to impose ESG disclosure requirements in the municipal securities market beyond the traditional materiality standard that currently governs all municipal disclosure.

The SEC also proposed on May 25, 2022, two sets of related amendments on [ESG disclosures for investment advisers and investment companies](#) and on [investment company names](#). Together, these proposals would,

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<sup>i</sup> Scope 1 emissions are direct GHG emissions that occur from sources that are controlled or owned by an organization (for instance, emissions associated with fuel combustion in boilers, furnaces, and vehicles). Scope 2 emissions are indirect GHG emissions associated with the purchase of electricity, steam, heat, or cooling. Scope 3 emissions are all indirect GHG emissions (not included in Scope 2) that occur in the value chain of the reporting company (such as purchased goods and services, business travel, employee commuting, waste disposal, transportation and distribution, leased assets, and franchises).

among other things, require funds and their advisers to disclose additional information regarding their ESG investment practices, as well as to adhere to additional practices and standards with respect to their invested assets designed to ensure consistency with fund names and terminology indicative of the fund’s focus or strategy, including in connection with ESG strategies. Comments are due on these proposals by August 16, 2022. While not directly applicable to municipal issuers, the proposed rule amendments, if adopted, potentially could have significant impacts on municipal issuers whose bonds are held by mutual funds and other investors engaging in ESG strategies, which may need to modify their standards and practices when investing in municipal securities to conform to their new ESG-related obligations.

Finally, the Supreme Court’s June 30, 2022, decision in *West Virginia v. Environmental Protection Agency*, in which the Court struck down an EPA regulation pertaining to carbon dioxide emissions because it constituted a major change in the law not contemplated by Congress, may have an impact on the SEC’s ability to adopt the more sweeping aspects of its ESG rulemaking agenda. Nonetheless, the SEC likely will continue to be empowered to take action to strengthen materiality-based disclosures that are more closely in line with existing anti-fraud disclosure standards in the municipal securities market.

### ***Elected Official Pushback Against ESG Analysis in the Rating Process***

To varying extents, certain of the rating agencies (including S&P, Moody’s, and Fitch) have begun to take ESG matters into consideration for their ratings of municipal issuers. This has sparked backlash from elected officials in certain states. In March 2022, S&P released ESG public finance report cards that assessed all 50 states on ESG-based metrics. These reports generated complaints from elected officials in Utah, West Virginia, Idaho, and Louisiana and requests that S&P withdraw or cease publishing ESG credit indicators for such states. The primary concern of these officials apparently is whether the use of ESG-based metrics politicizes the ratings process and could serve as a tool of “coercive capitalism.” In a [May 16, 2022](#), letter to the Utah State Treasurer, S&P’s head of public finance Eden Perry responded by saying “Our ESG credit indicators for Utah reflect those ESG credit factors that we consider

material to our analysis of Utah's creditworthiness. Accordingly, we cannot agree to your request to withdraw or to cease publishing ESG credit indicators for Utah. We will not allow any issuer to inappropriately influence our analytical processes or our credit rating opinions."

### ***Anticipated GFOA Best Practices on Designated ESG Bonds***

During the GFOA conference in June 2022, the debt committee announced that the likely subject of its next best practices report will be designated ESG bonds. GFOA has previously released best practices reports on disclosure relating to the "E," "S," and "G" factors in ESG, which were discussed in our [2021 Mid-Year Report](#) and [2021 Year-End Report](#), respectively. As of the publication of this newsletter, the designated bonds best practices report has not been released yet.

*A Municipal Securities Regulation and Enforcement Team Publication*

## **Contacts**

**Kimberly D. Magrini**, *Public Finance*  
*Municipal Securities Regulation and Enforcement*  
[magrinik@ballardspahr.com](mailto:magrinik@ballardspahr.com)  
215.864.8365

**William C. Rhodes**, *Public Finance*  
*Municipal Securities Regulation and Enforcement*  
[rhodes@ballardspahr.com](mailto:rhodes@ballardspahr.com)  
215.864.8534

**Teri M. Guarnaccia**, *Public Finance*  
*Municipal Securities Regulation and Enforcement*  
[guarnacciat@ballardspahr.com](mailto:guarnacciat@ballardspahr.com)  
410.528.5526

**Ernesto A. Lanza**, *Public Finance*  
*Municipal Securities Regulation and Enforcement*  
[lanzae@ballardspahr.com](mailto:lanzae@ballardspahr.com)  
202.777.6053

## **Conclusion**

While the first half of 2022 saw a general slowdown of municipal issuances, regulatory and enforcement actions continued apace, as did discussions around ESG practices, risk disclosure, and labeled-bond concerns. We expect the second half of 2022 to see a continued focus on ESG with the MSRB's anticipated town halls and the SEC's May 2022 proposed form and rule amendments related to corporate issuers that seek to enhance and standardize disclosures related to ESG factors considered by funds and advisers, and to also expand the regulation of the naming of funds with an ESG focus. Municipal market professionals will undoubtedly look to the proposed rule amendments applicable to public companies for analogous guidance on how regulators may view ESG disclosures in the municipal market context.

**Jennifer Brooks**, *Public Finance*  
*Municipal Securities Regulation and Enforcement*  
[brooksjp@ballardspahr.com](mailto:brooksjp@ballardspahr.com)  
303.299.7384

**John C. Grugan**, *Litigation*  
*Municipal Securities Regulation and Enforcement*  
[gruganj@ballardspahr.com](mailto:gruganj@ballardspahr.com)  
215.864.8226

**M. Norman Goldberger**, *Litigation*,  
*Municipal Securities Regulation and Enforcement*  
[goldbergerm@ballardspahr.com](mailto:goldbergerm@ballardspahr.com)  
215.864.8850

**Tesia N. Stanley**, *Litigation*  
*Municipal Securities Regulation and Enforcement*  
[stanleyt@ballardspahr.com](mailto:stanleyt@ballardspahr.com)  
801.531.3036