Comment submitted by the Competitive Enterprise Institute
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In the matter of the proposed rule
"**Investment Company Names**"
Securities and Exchange Commission
17 CFR Parts 232, 270 and 274
Release No. IC-34593; File No. S7-16-22
RIN 3235-AM72

Introduction

The Competitive Enterprise Institute (CEI) is pleased to have the opportunity to comment on the Securities and Exchange Commission's (SEC) current notice of proposed rulemaking, "Investment Company Names."[1] CEI has published research in support of free markets and limited government since 1984 and has long advocated policies that increase investor choice, eliminate barriers to economic growth, and protect Americans from abuse by government agencies. CEI policy experts frequently comment on a wide variety of regulatory policy topics, including finance, regulatory reform, and environmental policy issues. Recent regulatory and legislative comment letters from CEI policy scholars include submissions on climate disclosure,[2] capital formation,[3] and the Environmental Protection Agency's water quality rules.[4]

ESG Factors, and ESG Theory Itself, Are Inherently Subjective

In an online video from March 2022, Securities and Exchange Commission (SEC) Chairman Gary Gensler explains his concerns about investment products that market themselves as "green" or "sustainable."[5]

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[1] Securities and Exchange Commission, ""Investment Company Names" *Federal Register*, Vol. 87, No. 117 (June 17, 2022), pp. 36594-36651, https://www.federalregister.gov/documents/2022/06/17/2022-11742/investment-company-names. Portions of this comment letter were previously published online: Richard Morrison, "SEC's Gensler Wants to Regulate Green Funds, But Definitions Are Elusive," *Real Clear Policy*, May 3, 2022, https://www.realclearpolicy.com/articles/2022/05/03/secs_gensler_wants_to_regulate_green_funds_but_definitions_are_elusive_830237.html.

[2] Richard Morrison et al., "CEI Comments to SEC on Proposed Climate-Related Disclosures Rule," Competitive Enterprise Institute, June 16, 2022, https://cei.org/regulatory_comments/cei-comments-to-sec-on-proposed-climate-related-disclosures-for-investors-rule/. Marlo Lewis and Patrick Michaels, "CEI Comments on Proposed SEC Rule: Enhancement and Standardization of Climate-Related Disclosures for Investors," Competitive Enterprise Institute, June 17, 2022, https://cei.org/regulatory_comments/cei-comments-on-proposed-sec-rule-enhancement-and-standardization-of-climate-related-disclosures-for-investors/.

[3] Paul Jossey, "CEI Comments to Senate Banking Committee on JOBS Act 4.0," Competitive Enterprise Institute, June 7, 2022, https://cei.org/regulatory_comments/cei-comments-to-senate-committee-on-jobs-act-4-0/.

[4] Ben Lieberman, "CEI Comments to EPA Regarding Environmental Protection Agency, Clean Water Act Section 401 Water Quality Certification Improvement Rule," Competitive Enterprise Institute, August 8, 2022, https://cei.org/regulatory_comments/cei-comments-to-epa-regarding-environmental-protection-agency-clean-water-act-section-401-water-quality-certification-improvement-rule-proposed-rule/.

[5] Gary Gensler (@garygensler), March 1, 2022, 12:14 p.m., https://twitter.com/garygensler/status/1498708322677149700.

According to Chairman Gensler, hundreds of funds with trillions of dollars under management claim that their investments serve various environmental, social, and governance (ESG) goals beyond delivering returns to their clients. The current proposed rule amendments would require these funds to be regulated in such a way that investors can trust those claims as authoritative and valid. Unfortunately, that will likely not be possible. When it comes to claims of environmental and social virtue, the investing public will be better off living with the inescapable ambiguity of subjective terminology.

The agency explains the background of the current rule by pointing out that fund names that reference investment type (stocks or bonds), industry focus (utilities or healthcare), or geographical concentration (Japan or Latin America) are subject to an 80% value requirement.[6] But those examples have one important thing in common that does not apply to many of the topics covered by the current proposal: they are objective criteria. There is not a great deal of debate about how an equity share is different from a municipal bond or whether a given company is headquartered in Nagoya or San Salvador. The same cannot be said about what investment options count as "value," "growth," or—especially—"ESG."

The term ESG itself is merely the latest iteration in a long series of similar terms popularized over the last several decades that seek to emphasize an ethical corporate purpose beyond shareholder value maximization. These include concepts like "corporate social responsibility," "corporate social performance," "socially responsible investing," "the triple bottom line," and "shared value creation." The single most consistent feature in the long history of ESG and its precursor concepts—in both academic literature and industry analysis—is the repeated distress voiced by management, finance, and economics experts at the confusion they engender.[7]

The confusion and inconsistent definitions endemic to the world of ESG analysis are also not, as some advocates have claimed, merely the growing pains of an infant concept destined to mature into a substantial and reliable field. The problem with ESG theory is that it is inherently subjective and not conceptually amendable to the kind of rigor needed for governmental policymaking, especially if there are non-trivial legal sanctions awaiting regulated parties that act in ways inconsistent with such rules. The term "corporate social responsibility"—which is conceptually very similar to what most commenters mean when they use the phrase "ESG" today—was discussed in detail at least as early as the 1950s.[8] If its proponents were capable of describing their goals and definitions in objective detail, they would have done so by now.[9]

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[6] Securities and Exchange Commission, p. 36595.

[7] Richard Morrison, Environmental, Social, and Governance Theory: Defusing a Major Threat to Shareholder Rights," *Profiles in Capitalism* No. 6, Competitive Enterprise Institute, May 2021, p. 6, https://cei.org/esg.

[8] Howard R. Bowen, *Social Responsibilities of the Businessman* (Iowa City, Iowa: University of Iowa Press, 1953).

[9] The Commission stipulates (p. 36599) that "terms like 'green' or 'sustainable' may be more subjective than a term like 'large cap equity' and thus not always viewed as referring to a 'type' of investment." This is a welcome admission, but the analysis that follows it fails to take that statement seriously. Terms like "green" and "sustainable" are not simply *more* subjective, they are categorically so.

The lack of internal rigor in ESG analysis has been widely discussed in recently years, with valuable contributions by researchers like Florian Berg, Julian F. Koelbel, and Roberto Rigobon at MIT Sloan,[10] John West and Ari Polychronopoulos of Research Affiliates,[11] and Bradford Cornell of UCLA and Aswath Damodaran of New York University.[12] Similar verdicts from the world of policy and news analysis abound as well. Harriet Agnew, Adrienne Klasa, and Simon Mundy of the *Financial Times* declared in June that ESG "may already be coming to the end of its useful life."[13]

The Commission Should Decline to Force a Definition on Subjective Claims

In his March 2022 video, Chairman Gensler says that the goal of the proposed rules is that "when a fund company uses a name, you should be able to read that name and trust what it says." He then goes on to make a relatable comparison: Investment funds should be like a carton of skim milk. When you go to the supermarket and you see a carton of skim milk on the shelf, you can trust that it is actually fat free, because food companies are required to print the fat content on the carton and may not advertise a product name or description inconsistent with that fact.

The problem with generalizing this idea to investing, and especially to ESG criteria, is that the issues that the current proposal considers are not simple and quantifiable. The terms cited, such as "green" and "sustainable," are inherently subjective and hotly contested.[14] You can send a sample of milk to a chemistry lab for analysis and confirm its fat content, but no quantitative process can decisively adjudicate whether investing in, say, nuclear energy rather than wind power is "better for the environment." That's a value judgement. How heavily, for example, should we weigh concerns about long-term storage of radioactive waste vs. the number of birds killed by turbine blades each year? Should we prioritize infrastructure that can be built quickly or that will last the longest? There is no single objective answer to these questions.

Thus, there can be no single correct answer to which investment fund is truly "sustainable" or "environmentally friendly," because both finance professionals and investors disagree about how those things should be measured. It's perfectly reasonable for the agency to raise concerns about potential investor confusion, but solving that confusion with an arbitrary and rigid government definition will not improve the situation.

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[10] Florian Berg, Julian F. Koelbel, and Roberto Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings," MIT Sloan School Working Paper 5822-19, May 17, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533.
[11] John West and Ari Polychronopoulos, "Is ESG a Factor?" Research Affiliates, July 2020, https://www.researchaffiliates.com/en_us/publications/articles/813-is-esg-a-factor.html.
[12] Bradford Cornell and Aswath Damodaran, "Valuing ESG: Doing Good or Sounding Good?" *Journal of Impact and ESG Investing*, Vol. 1, No. 1 (Fall 2020), pp. 76-93; https://doi.org/10.3905/jesg.2020.1.1.076.
[13] Harriet Agnew, Adrienne Klasa and Simon Mundy, "How ESG investing came to a reckoning," *Financial Times*, June 6, 2022, http://advisorsavvy.com.advisor.news/how-esg-investing-came-to-a-reckoning.
[14] Doug King, "Why the word 'sustainability' should be banned," *The Guardian*, August 29, 2013, https://www.theguardian.com/environment/blog/2013/aug/29/meaningless-word-sustainability-banned. Anneken Tappe, "Investing green is harder than you'd think," CNN, August 16, 2021, https://www.cnn.com/2021/08/16/economy/green-investing-stocks-etf/index.html.

Going forward, our best option is to acknowledge what we currently have now: a bifurcated system. The current fund names rule (and other more general anti-fraud provisions) protect investors from specific, clearly false claims. We also should maintain an open arena for inherently subjective names, expecting individual investors to perform the due diligence necessary to evaluate any subjective representations implied by a fund's name.

The Commission's proposal notes that "many investors often rely on fund names, rather than disclosures such as those concerning the fund's objective, strategies, and risks, when making an investment decision."[15] Since the subjective terminology in question cannot be magically made rigorous by administrative fiat, the best solution is for the Commission to expand its detailed investor education programming to alert potential investors to this fact. For example, the agency's alerts and bulletins could advise Americans on how to evaluate subjective fund names and claims without attempting to decide for them what "green" actually means.[16]

While big concepts like sustainability don't have a single objective definition, some environmental terminology does. A firm could easily create and market a fund that tracks corporations that are co-signers of the United Nations-sponsored Principles for Responsible Investment or that have adopted the methodology recommended by the Sustainability Accounting Standards Board. Many funds already exclude oil and gas companies or only invest in wind and solar technology. Those are fairly straightforward distinctions. If a company advertises a fund based on those *objective* criteria, it needs to deliver; no firm should be allowed to mislead investors with fraudulent statements. Customers who are motivated to pursue what they consider to be "sustainable" investment products should thus be encouraged to seek out the most specific—and easily falsifiable—claims when shopping for funds.

When it comes to vaguer terms, the SEC should follow the Federal Trade Commission's (FTC) approach to product claims. The FTC polices advertising claims that are outright lies but not those that are recommendations, general characterizations, or what are sometimes called "puffery."[17] As with the skim milk example, a company cannot claim that its hot dogs are 100 percent beef if they are 50 percent pork, but it can claim that they are "the tastiest hot dogs in the world"—an inherently subjective claim. It's up to each consumer to weigh conflicting product claims and determine if, in their experience and by their own judgement, such subjective assertions are valid.

Many ESG and sustainability claims are like the tasty hot dog. It's a mistake to even ask if they're "true" or not, because different people have different perspectives on what meets those definitions. We can agree on where pork comes from, but we will likely disagree on the advisability of eating it. It is not the job of the Federal Trade Commission to survey every American on their taste in packaged foods to determine whether a hot dog manufacturer could brag about its product's subjective qualities. The SEC expanding its mission to do the equivalent for "clean energy" funds would be equally quixotic.

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[15] Securities and Exchange Commission, p. 36599.

[16] Securities and Exchange Commission, "Investor Alerts and Bulletin," https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins, accessed August 12, 2022.

[17] Roscoe B. Starek, III, "Myths and Half-Truths About Deceptive Advertising," Federal Trade Commission, October 15, 1996, https://www.ftc.gov/news-events/news/speeches/myths-half-truths-about-deceptive-advertising.

This is true even if the Commission plans to rely on managers of ESG-named funds to self-certify that they have "considered" ESG factors affecting 80% of their portfolio. Self-certification would be preferable to the Commission erecting its own comprehensive framework for what are and what are not ESG-compatible investment products, but it would not address the agency's concerns about clarity and reliability. The sort of zero-content box checking that would ensue would simply be an excuse for more paperwork and ultimately tell investors nothing that could not be learned by reading the fund's prospectus.

For example, some investors would expect a "clean energy ESG" fund to consist entirely of companies that produce wind and solar power. Some would include hydropower, despite many environmental activists calling for existing hydropower dams to be removed to improve fish habitat.[18] Others would be happy for it to include construction, uranium mining, and advanced engineering firms, because such companies are necessary for expanding nuclear generation facilities.[19] But if such a wide array of options are acceptable—as they should be—what is the point of creating an entirely new set of requirements?

The SEC should fight actual fraud wherever it finds it. It should not, however, attempt to regulate concepts that have no objective definitions. To the extent that consumers need protection and guidance, the SEC should use its existing educational programs to teach them how to evaluate subjective claims in investment products, just as it teaches them how to evaluate different options and opportunities regarding brokerage accounts, financial privacy, and retirement savings.

[18] Nicholas K. Geranios, "Feud breaks out among Pacific Northwest GOP lawmakers over Snake River dams," Associated Press, May 6, 2021, https://www.registerguard.com/story/news/2021/05/06/controversial-snake-river-dam-proposal-causes-feud-among-gop-lawmakers/4974732001/.

[19] Rebecca Tuhus-Dubrow, "The Activists Who Embrace Nuclear Power," *The New Yorker*, February 19, 2021, https://www.newyorker.com/tech/annals-of-technology/the-activists-who-embrace-nuclear-power.