CATO INSTITUTE | Center for Monetary and Financial Alternatives

August 12, 2022

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: *File No. S7-16-22*
Investment Company Names

Dear Ms. Countryman:

My name is Jennifer Schulp, and I am the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives. I appreciate the opportunity to comment on the Securities and Exchange Commission's proposed amendments to the "Names Rule" under the Investment Company Act of 1940, which addresses "certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks."[1] The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives focuses on identifying, studying, and promoting alternatives to centralized, bureaucratic, and discretionary financial regulatory systems. The opinions I express here are my own.

Section 35(d) of the Investment Company Act provides that "[i]t shall be unlawful for any registered investment company to adopt as part of the name or title of such company, or of any securities of which it is the issuer, any word or words that the Commission finds are materially deceptive or misleading."[2] The provision also authorizes the Commission "to define such names or titles as are materially deceptive or misleading," which the Commission did in 2001 by promulgating what the Names Rule.[3] Under this rule as it currently stands, the Commission considers the name of a fund to be "materially deceptive and misleading" if it— most relevantly to the proposed amendments—suggests that the fund invests in certain investments or

[1] Notice of Proposed Rule ("Notice"), "Investment Company Names," SEC Release Nos. 33-11067; 34-94981; IC-34593; File No. S7-16-22 at 1, https://www.sec.gov/rules/proposed/2022/33-11067.pdf.
[2] 15 U.S.C. § 80a-34(d).
[3] *Id.*; 17 C.F.R. § 270.35d-1.

industries, certain countries or geographic regions, or is tax-exempt, unless the fund invests at least 80% of the value of its assets as suggested by the fund's name. This proposal, among other things, seeks to expand the scope of the Names Rule to require that where a fund's name suggests an "investment focus," the fund must invest 80% of its assets in accordance with that "focus."

The Commission justifies the proposal as "modernizing" the existing Names Rule and increasing investor protection.[4] In addition, though it is only mentioned in passing in the Notice, these proposed amendments are intended to rein in "greenwashing" in the investment management industry, particularly where the amendments seek to impose additional requirements on funds claiming some connection to "environmental, social, and governance," or ESG, investing.[5]

Greenwashing generally is when an investment presents itself as being more environmentally friendly or socially responsible than it actually is. Pinpointing when an investment is greenwashed is difficult—if not impossible—due to the many different understandings of what it means for an investment to be considered green or sustainable. Indeed, in many respects, whether an investment is environmentally friendly or socially responsible is in the eye of the beholder.[6]

This inherent subjectivity and lack of consensus calls into question whether combatting greenwashing is a realistic goal. But, regardless of what greenwashing specifically means, the Commission has long been tasked with ensuring that investors receive the investment that they are promised, and the Commission already has rules to prevent investors from being misled. As the Commission already has pointed out—and proposes to do even more clearly with these proposed amendments—the Names Rule is not "intended to be a safe harbor for materially deceptive or misleading names."[7] In other words, the Commission can bring an action against a fund for materially deceptive or misleading names, regardless of whether the fund meets the standards set out in the Names Rule. In addition to this Section 35(d) authority, the Commission has other authorities that govern how investment funds and their advisers communicate with

[4] *See* Notice at 11, 1.
[5] *See id.* at 14.
[6] That's not to dispute that greenwashing is a concern to investors (or consumers, more generally). Recent polling points out that strong majorities of adults, and those who identify as frequent investors, agree that "it is hard to prove whether a company is [as] environmentally friendly [as] it claims to be." Amanda Jacobson Snyder, "As SEC Closes In on ESG Rules for Funds, the Bulk of Frequent Investors Say They Value Such Standards," *Morning Consult*, July 12, 2022, https://morningconsult.com/2022/07/12/sec-rules-esg-investments-survey-data/. The problem with regulations aimed at remedying this problem is that there is no accepted definition about what it means to be "environmentally friendly."
[7] Notice at 10.

their investors, including anti-fraud rules.[8] The Commission has recently used these tools to address similar issues in the ESG investment context. [9]

There is little about this proposal that will enhance the Commission's exercise of its existing authority under existing rules. Instead, as explained below, these amendments fail to create a workable framework for fund naming and have the potential to harm, rather than protect, investors. The Commission should not proceed with the proposed amendments in their current form.

The Proposed Amendments Do Not Create A Workable Framework For Fund Naming

While the proposed amendments seek to change a number of requirements (and add new ones), the most notable change proposed is expanding the scope of the Names Rule to require that where a fund's name suggests an "investment focus," the fund must invest 80% of its assets in accordance with that "focus." This would alter the current Names Rule, which does not apply to fund names suggestive of an "investment strategy,"[10] by creating a new category of names subject to the Rule. Adding a third category of names—investment focused names—will increase, rather than decrease, interpretive challenges. Moreover, the inherent subjectivity of terms such as ESG, growth, and value make the application of a bright line 80% rule difficult to apply. The proposed amendments requiring funds to ensure that any deviations from the funds' 80% policy are remedied within 30 days are also unduly restrictive. Taken together, these proposed amendments fail to establish a coherent, workable framework that funds can adhere to.

"Investment Focus" Will Create Insurmountable Interpretive Issues

The Commission justifies the proposed amendments, in part, as alleviating the interpretive challenges of determining whether a fund's name describes a product and is subject to the Names Rule or describes an investment strategy and is exempt from the Names Rule.

But the proposed amendments' solution sows more interpretive challenges than it solves by creating a third category of fund names—i.e., those that "suggest that the fund focuses in investments that have, or whose issuers have, particular characteristics."[11] The examples that the Commission gives of fund names that will not be subject to the Names Rule—such as target

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[8] *See, e.g.,* 15 U.S.C. § 80b-6; 15 U.S.C. § 80a-33; 17 C.F.R. §275.206(4)-8; 17 C.F.R. § 275-206(4)-1.
[9] *See, e.g., In re BNY Mellon Investment Adviser, Inc.*, Order Instituting Administrative Proceedings and Cease-and-Desist Proceedings, Administrative Proceeding File No. 3-20867, Investment Advisers Act of 1940 Release No. 6032, Investment Company Act of 1940, Release No. 34591 (May 23, 2022), https://www.sec.gov/litigation/admin/2022/ia-6032.pdf.
[10] *See* Investment Company Names, Investment Company Act Release No. 24828, 66 Fed. Reg. 8509 (February 1, 2001) at n.43, https://www.federalregister.gov/documents/2001/02/01/01-1967/investment-company-names.
[11] Notice at 19.

date fund names and those that claim to be "balanced"—offer little guidance on drawing the line between whether a name connotes a "focus" or a "strategy."

The suggestion that the test turn on whether a "reasonable investor" views the fund name as suggesting an investment focus merely muddies the water further.[12] This distinction is so vague as to be unworkable, and it may incentivize investment companies to use generic or uninformative naming to avoid these interpretive questions. A rule that encourages less informative fund names would not benefit investors.

Subjective Terms Should Not Be Subject To Fund Naming Rules

What distinguishes applying the Names Rule's 80% investment threshold to investment products from applying the same threshold to an "investment focus" is the degree of subjectivity inherent in evaluating the terms. While it is tempting to see an 80% investment threshold as simply "truth-in-advertising," as Chair Gary Gensler has often described it,[13] the subjective nature of the terms that would be newly subject to the Names Rule means that there often is no one "truth" to be advertised. Terms such as "ESG," "growth," and "value" are difficult to define with precision, are implemented differently from one fund to another, and are subject to varied understandings and expectations from one investor to another. Applying an 80% investment threshold to such terms accordingly requires a subjective judgment about what the terms mean.

The Commission recognizes this subjectivity by, correctly, not proposing to define ESG or other terms. It neither identifies criteria that a fund must meet to be labeled ESG nor identifies criteria that an investment must meet to be considered by the fund to be part of the 80% investment basket. But the inability to define these terms by regulation creates two problems.

First, the fund's name will be no more descriptive than it is without the imposition of the 80% rule. The Commission claims that the proposed amendments advance investor protection because investors "may reasonably expect funds with [ESG] names to invest in companies with policies, practices, or characteristics that are consistent with [ESG] standards."[14] But where ESG has no agreed-upon meaning, investors' expectations cannot be met simply by mandating that a fund meet certain investment minimums. Because investors' expectations will vary, as will the intention of the investment company in using the name, investors must dig further to understand the fund's investments and strategies, regardless of the fund's name. If an amended Names Rule seeks to permit investors to rely on concise names to describe what is in

[12] *Id.* at 20.
[13] *See, e.g.,* Gary Gensler, "Prepared Remarks Before the Asset Management Advisory Committee," July 7, 2021, https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07.
[14] Notice at 13-14.

the fund, applying the Names Rule to this "investment focus" does no such thing.[15] Notably, the Commission does not consider enhanced disclosure by itself, without a bright line 80% rule, as an alternative when analyzing the proposed amendments.[16]

Second, even without a formal definition, the Commission will remain the arbiter of what does, and does not, qualify as ESG under the Names Rule. But rather than submitting a definition to notice and comment rulemaking, and providing clear guidelines to investment companies about what qualifies, Commission staff will exercise their judgement about whether the investment companies' interpretation of ESG terms is "reasonable."[17] Applying unrestrained judgment in these circumstances—where a term lacks a consensus definition, may be subject to shifting definitions, and is politically charged—has the potential to place the Commission in the unacceptable position of, as Commissioner Hester Peirce dubbed it, "Monday morning asset managing."[18] The Commission should not be determining what does, and does not, count as ESG, because the Commission is not—and should not be—in the business of deciding what is good for the environment and society.

Proposed Temporary Deviation Rules Are Too Restrictive

The proposed amendments also restrictively require a fund that deviates from its 80% investment policy to return to compliance within 30 consecutive days.[19] The Commission cites scant evidence that the current rule, which requires funds to meet the 80% policy "under normal circumstances,"[20] either is being abused or results in materially deceptive or misleading fund names.

Not only is the timeframe prescriptive, it is arbitrary; the Commission points to no reason why lack of compliance for more than 30 days is per se misleading to an investor. The Commission merely notes that "at some point, departures may begin to change the nature of the fund

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[15] Conveying concise information about an investment strategy, however, may occur through private non-governmental efforts to create standards and classifications for ESG investments. *See, e.g.,* CFA Institute, "Request for Comments on Fund Names," May 5, 2020, https://www.sec.gov/comments/s7-04-20/s70420-7153850-216453.pdf (describing efforts to develop "an industry standard for the classification and disclosure of ESG investment products").

[16] Nor does the Commission consider whether the disclosures proposed in its simultaneously issued notice of proposed rulemaking relating to enhanced disclosures by investment advisers and investment companies about ESG investment practices will provide investor clarity. *See* Notice of Proposed Rule ("Fund Disclosure Notice"), "Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices," SEC Release Nos. 33-11068; 34-94985; IC-34594; File No. S7-17-22, https://www.sec.gov/rules/proposed/2022/33-11068.pdf.

[17] *See, e.g.,* Notice at 74-75.

[18] Hester M. Peirce, "Statement on Investment Company Names," May 25, 2022, https://www.sec.gov/news/statement/peirce-fund-names-statement-052522.

[19] Notice at 34.

[20] *See id.* at 16, 34-35.

fundamentally," before concluding that a 30-day limit is "designed to present such a fundamental change."[21] Moreover, such a short period is likely to be difficult for funds to manage, particularly where unusual circumstances have caused the fund to go out of alignment with its investment policy. These difficulties are not merely administrative, as a short time period may cause the sale of portfolio holdings at times that are not economically advantageous to the fund's investors. Funds may also choose to avoid certain investments—like those that are volatile or less liquid—that would otherwise fit their investment strategy for fear that those investments may make it more difficult to meet the restrictive rules regarding compliance deviations. Rather than protecting investors, such a restrictive time period may result in investor harm. At a minimum, the Commission should expand the time frame by which a fund must return to compliance.

The Proposed Amendments Have The Potential To Harm Investors

Rather than strengthen investor protection, as the Commission claims, the proposed amendments may leave investors worse off, decreasing their choice of investment options and providing a false sense of security about whether a fund's investment strategy meets their expectations.

The Proposed Amendments Will Limit Fund Diversity and Investor Choice

While the proposed amendments may lead to more homogeneous investment strategies in multiple ways, as discussed above, the most direct impact will be through eliminating the ability of integration funds to signal through their names to potential investors that they are considering ESG factors in their investment decisions. The Commission defines integration funds as those that "consider one or more ESG factors alongside other, non-ESG factors in the fund's investment decisions," and the proposed amendments would consider fund names that describe such a strategy to be "materially deceptive and misleading."[22]

This prohibition conveys a view from the Commission that integration funds are not worthy of an "ESG" label, wrongfully putting the Commission's thumb on the scale in favor of ESG-focused or ESG-impact funds. When combined with the heightened disclosure to be required of integration funds under the simultaneously issued proposal for fund disclosures,[23] the inability of these funds to signal their strategies in their concise titles makes it far more likely that at least some of these funds will choose to alter their strategies. Whether the choice results in not considering ESG factors or giving more weight to ESG factors, the result is less diverse investment strategy offerings for investors.

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[21] *Id.* at 37-38.
[22] *Id.* at 81.
[23] *See* Fund Disclosure Notice at 25, *et seq.*

Bright Line Rules For Fund Naming On Subjective Subjects May Mislead Investors

A fund's name is just one small piece of information about the fund. As the Commission has recognized, the "name of a fund may communicate a great deal to an investor," but investors should not rely on "a fund's name as the sole source of information about the fund's investments and risks."[24] Yet, the proposed amendments are intended to support an investor's reliance on the fund's name to convey information about the fund's strategy, investments, and risks. Given the diversity of legitimate ESG strategies that a fund may be implementing—and the fact that investors are likely to apply their own definitions of ESG when reading an investment's name—investors must be encouraged, as Commissioner Peirce has noted, "to look beyond names to fund disclosure documents."[25] The Commission's assurances that the fund must be invested 80% according to its name do little to ensure that investors are finding funds that match their expectations, and may mislead investors who should otherwise look deeper into the fund's documents to understand the investment. Where there is no consensus as to the meaning of terms that the Commission seeks to regulate, it is less misleading to acknowledge the lack of consensus and encourage investors to be skeptical of claims and to do their homework. The proposed amendments, in contrast, may give investors false confidence that the Commission has ensured that the funds are investing in a manner consistent with their expectations. Rather than preventing investors from being misled or deceived, these proposed amendments could have the opposite effect.

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Thank you for the opportunity to comment on these proposed rule amendments, and I am happy to answer any questions or further engage on this topic.

Sincerely,

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Center for Monetary and Financial Alternatives
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[24] Notice at 5.

[25] Hester M. Peirce, "Statement on Investment Company Names," May 25, 2022, https://www.sec.gov/news/statement/peirce-fund-names-statement-052522.