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Comment to the Securities and Exchange Commission On the "Investment Company Names" Proposed Rule

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https://www.sec.gov/cgi-bin/ruling-comments

This comment is submitted to the Securities and Exchange Commission on the proposed rule on "Investment Company Names."[1] The central conclusion is straightforward: Because the proposed rule ignores basic fundamentals of market competition, it would yield few if any economic benefits for investors while imposing substantial costs. Accordingly, it should not be finalized in its current form. This comment is organized as follows:

Summary.
- The Misleading Nature of the Terms "Deceptive" or "Misleading."
- Can Every Investor Be Fooled? The Discipline Imposed by Marginal Investors and the Economic Returns to Reputational Capital.
- "Environmental, Social, and Governance" Funds and the Problem of Non-Definition.
- Conclusions: This Proposed Rule Is Fundamentally Deceptive and Incoherent.

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[1] The proposed rule has been published as File No. S7-16-22, RIN 3235-AM72 in the Federal Register at https://www.govinfo.gov/content/pkg/FR-2022-06-17/pdf/2022-11742.pdf.

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Summary. The terms “deceptive” or “misleading” as applied to the names of firms or funds are fundamentally problematic as an analytic matter because the degree to which investors are deceived or misled is determined by the conclusions that they derive, which regulators cannot know. Moreover, the possibility that an investor might rely upon a fund name “inordinately” is a driving concept without definition, and thus is likely to be arbitrary and capricious, particularly given that fund names are the result of market competition driven by the reality that information is costly, and thus that the acquisition of such information must be economized.

Moreover, even if many investors are deceived or misled by the names of firms or funds, it is the behavior of marginal investors that matters in terms of market efficiency. It is impossible to believe that *all* investors are deceived or misled, so that the actions of marginal investors in terms of imposing penalties upon firms and funds with deceptive or misleading names will yield an efficient market outcome, one that in particular compensates investors for the costs of any deception or decisions reflecting misleading information that they might incur. At a more fundamental level, the implicit argument that firms or funds have incentives to mislead or to adopt deceptive names is not correct. The long-term interest of the firms and funds is driven by the pursuit of capital costs lower rather than higher, so that honesty as a practice yields an implicit capital asset — perhaps “reputation” is a good characterization — that earns a competitive rate of return.

The problem of defining the terms “deceptive” and “misleading” is particularly egregious in the context of ESG investments. Because the “environmental” nor “social” nor “governance” dimensions can be defined, there is no plausible analytic means with which to determine the degree to which investors are being deceived or misled, even apart from the other problems already discussed. Even within the “environmental” dimension, the ubiquitous references to “environmental justice” simply ignore the various tradeoffs that are relevant, and so are immune to any attempts at definition or measurement.

This proposed rule is poorly conceived and would impose economic costs vastly greater than any efficiency gains that it might engender. It should not be finalized.

The Misleading Nature of the Terms “Deceptive” or “Misleading.” Nowhere in the proposed rule is there a definition of the terms “deceptive” or “misleading.” Instead, the proposed rule asserts that

> Congress provided the Commission with rulemaking authority to address materially deceptive or misleading fund names, recognizing the concern that investors may rely inordinately on a fund’s name to determine its investments and risks.[2]

This analytic gap is unsurprising in that the degree to which a fund name or, for that matter, any other statement, assertion, or parameter is “deceptive” or “misleading” depends crucially upon the degree to which an investor or other relevant party actually is deceived or misled. That requires an observer — a regulator in this context — to know what thoughts or conclusions, even if only tentative, are formulated by a given investor or group of investors when

[2] See the proposed rule at p. 36596.

confronted with the fund name. Obviously, the regulator cannot know that, in that the regulator is not a mind-reader notwithstanding the implicit assumption driving the "analysis" underlying this proposed rule.

In short, the regulator may believe that a fund name is "deceptive" or "misleading," but even if that belief is assumed true in some metaphysical sense, it does not follow that any given investor actually is deceived or misled. Again: That far more fundamental parameter is driven by what goes through the given investor's mind when confronted with a fund name, and, again, no regulator can know that.

That is why the proposed rule descends into a purported concern that "investors may rely inordinately on a fund's name to determine its investments and risks." It certainly is true, or reasonable to assume, that investors rely upon a fund's name as a source of summary information, because information is costly to obtain. For investors — and regulators — such summary parameters as names are an economizing device. But precisely what does "inordinately" mean? Unless regulators know the magnitude of the relevant information costs and the tradeoffs between such costs, the private benefits of the acquisition of information more detailed, and marginal investment choices, the definition of an "inordinate" reliance upon "a fund's name to determine its investments and risks" is wholly obscure. Accordingly, the proposed rule does not offer one, and it is obvious that no such definition underlies it. The proposed rule in effect imposes (or assumes) a thought process on the part of *investors* driven by the same processes and assumptions underlying the thinking of *regulators*; but because investors and regulators, driven by the familiar process of market specialization, are hardly identical as an intellectual matter, that implicit assumption underlying the proposed rule is untenable.

Can Every Investor Be Fooled? The Discipline Imposed by Marginal Investors and the Economic Returns to Reputational Capital. As just discussed, the implicit premise that investors systematically might be deceived or misled by fund names *is deeply dubious as a regulatory matter*, in that regulators cannot know what conclusions investors derive from a fund name, that is, what goes through their respective minds. But assume for discussion purposes that some nontrivial set of (or most) investors are deceived or misled by a fund name. The question that ensues: *Does it matter in terms of the economic returns to such investments, that is, are those investors likely to be harmed?* The answer is "no," unless *all* such investors are misled. If a (small) subset of investors — the marginal investors — are not deceived or misled, then they will refuse to invest (or will disinvest) in the given fund, driving down the price of shares and thus imposing upon the fund a penalty for the "deceptive" or "misleading" fund name. In the market equilibrium, investors will be compensated for the "deceptive" or "misleading" fund names in the form of lower prices for shares and thus a restoration of competitive expected returns. In short, market competition will obviate the need for regulation.

That analytic observation is strengthened by the powerful long-term incentives of public companies — always interested in reducing the cost of obtaining capital from investors and lenders — to preserve their credibility by offering the economically-efficient amount of truthful information to the capital market.[3] Nowhere in the proposed rule is there an examination of

[3] The economically efficient amount of truthful information is not "full" information in that both the provision and the assimilation of such information are not costless. See, e.g., Benjamin Klein and Keith B. Leffler, "The Role of

precisely why a fund would choose to mislead investors; the implicit assumption is that profitability can be enhanced by doing so. That simply is not correct; credibility is an economic asset that earns a return determined by market competition. It is perhaps unsurprising that regulators might view market incentives as insufficient to engender an efficient outcome in terms of the provision of information, and that a regulatory strengthening of such incentives automatically would yield an allocational improvement. That stance is very far from obviously correct.

"Environmental, Social, and Governance" Funds and the Problem of Non-Definition. The proposed rule does not offer a definition of "environmental, social, and governance" (ESG) investments for the obvious reason that no such agreed definition exists.[4] Because no definition of the terms underlying ESG investments is available, no one can know if a fund name including ESG terms (or analogues) is "deceptive" or "misleading." Nor does the SEC "Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices" proposed rule offer any such definition.[5] There is the further matter that ESG objectives, however defined, inexorably conflict. To the extent that the "environmental" dimension is defined in terms of the central "climate" objective to reduce emissions of greenhouse gases (GHG), higher energy costs are the inevitable result; there is no plausible interpretation of the voluminous data that would yield a different conclusion.[6] Such higher energy costs must have the effect of reducing the economic wellbeing of customers, employees, and society writ large to the extent that reductions in GHG emissions are pursued on an economy-wide scale.[7]

The incoherence of this proposed rule is illustrated well by the possibility that a fund name might incorporate "environmental justice" either explicitly or implicitly. The U.S. Environmental Protection Agency defines "environmental justice" as follows:

> Environmental justice is the fair treatment and meaningful involvement of all people regardless of race, color, national origin, or income, with respect to the development, implementation, and enforcement of environmental

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Market Forces in Assuring Contractual Performance," *Journal of Political Economy*, vol. 89, No. 4 (August 1981), pp. 615-641, at https://www.jstor.org/stable/1833028?seq=1.

[4] The Organization for Economic Cooperation and Development in effect defines ESG investing as the pursuit of "sustainable finance," a definition that is not helpful in that "sustainability" itself as a concept is meaningless. See https://www.oecd.org/finance/esg-investing.htm. The U.S. Environmental Protection Agency defines sustainability as the "simple principle" that "Everything that we need for our survival and well-being depends, either directly or indirectly, on our natural environment. To pursue sustainability is to create and maintain the conditions under which humans and nature can exist in productive harmony to support present and future generations." Needless to say "productive harmony" is not a concept that yields analytic rigor. See https://www.epa.gov/sustainability/learn-about-sustainability.

[5] See the proposed rule at https://www.sec.gov/rules/proposed/2022/33-11068.pdf. See my comment at https://www.sec.gov/comments/s7-17-22/s71722-20137867-308205.pdf.

[6] For a discussion, see pp. 37-50 at https://www.aei.org/wp-content/uploads/2019/04/RPT-The-Green-New-Deal-5.5x8.5-FINAL.pdf.

[7] Higher energy costs must harm customers because of the attendant adverse price impacts. The increase in energy costs and output prices must yield downward pressure on wages determined in competitive markets by the value of the marginal product. For the economy (society) writ large, higher energy costs must reduce the size of the aggregate basket of goods and services. See *Ibid.*, pp. 13-29.

> laws, regulations, and policies. This goal will be achieved when everyone enjoys: [t]he same degree of protection from environmental and health hazards, and [e]qual access to the decision-making process to have a healthy environment in which to live, learn, and work.[8]

Accordingly, the "environmental justice" issue is defined in terms of differing levels of environmental quality experienced by various groups — "the same degree of protection from environmental and health hazards" — the poor and minority groups in particular. But that is too narrow a focus: Environmental quality is one component of "health" broadly defined, and it is clear from the scholarly literature that "health" is a "normal" good, that is, one the consumption of which rises with income or wealth. This is true for individuals and for economies as a whole.[9]

Therefore, it is unsurprising that lower-income individuals and households tend to be located in areas with lower environmental quality; that is what they can afford. This is a reality regardless of the impacts of differences in environmental quality on "health," that is, mortality and morbidity. Even if a lower level of environmental quality is merely unpleasant (as distinct from unhealthful), that is a factor relevant to the ways in which individuals and households allocate their limited resources.

A fund ostensibly pursuing "environmental justice" as usually formulated — would this mean disinvestment from industrial activity in geographic areas disproportionately poor, and thus a decline in employment opportunity in those areas? — in effect would be driven by the truism that there are poor people in this world who consume less environmental quality than others, that is, that they choose to allocate their resources in ways different from those exhibited by individuals and households wealthier. Even apart from the more general tradeoffs inherent in the concept of ESG investing whatever the underlying definitions, the inconsistencies inherent in the individual ESG components are important, but are not addressed by this proposed rule.

Conclusions: This Proposed Rule Is Fundamentally Deceptive and Incoherent. The terms "deceptive" or "misleading" as applied to the names of firms or funds are fundamentally problematic as an analytic matter because the degree to which investors are deceived or misled is determined by the conclusions that they derive, which regulators cannot know. Moreover, the possibility that an investor might rely upon a fund name "inordinately" is a driving concept without definition, and thus is likely to be arbitrary and capricious, particularly given that fund names are the result of market competition driven by the reality that information is costly, and thus that the acquisition of such information must be economized.

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[8] See https://www.epa.gov/environmentaljustice.

[9] See, e.g., https://www.bls.gov/opub/btn/volume-9/how-have-healthcare-expenditures-changed-evidence-from-the-consumer-expenditure-surveys.htm.

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