NATIONAL REVIEW

The SEC's Green Name Game

The agency is not — and should not be — in the business of deciding what is good for the environment and society.

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When considering the prospect of "green" finance, I'm often tempted to burst into song: Green, green, bo-bean, bo-na-na fanna, fo-fean, fee fi mo-mean. Green! Perhaps this can be attributed to my children, who are entranced by the rhymes in Shirley Ellis's iconic song, "The Name Game." Yet rather fortuitously, that song can actually help us in thinking about how to name investment products.

While determining what "green" means — or what qualifies as such — is not a new endeavor, the Securities and Exchange Commission (SEC) has recently begun to wrestle with it for investment products. As funds advertising themselves as green or ESG (environmental, social, and governance) reap record inflows, there's growing concern that investments may not be as environmentally or socially "responsible" as the products' marketing implies. Some call this "greenwashing" — a term first coined more than 30 years ago by an environmentalist who was skeptical of the hotel industry's encouragement of reusing towels to save the environment — but it's easy to think of it as bending the term green beyond any meaning, just as Ellis's song does.

Investment funds claiming to be ESG-focused or ESG-friendly may follow a myriad of different strategies — some of them genuine, others not. But what, if anything, should the SEC do about it? Everyone agrees that investors should not be deceived; that's why the SEC already has plenty of tools at its disposal to ensure that funds live up to their promises to investors. Yet classifying investments as green or sustainable seems to be an entirely separate matter — far beyond the SEC's remit and its capabilities.

Unfortunately, the SEC seems to be seriously considering requiring funds to meet standards in order to use ESG-related marketing terms.

It's tempting to see that condition merely as a "truth in advertising" regulation, as SEC chairman Gary Gensler has attempted to couch it. But such regulations are easiest to enforce and least distortive when the "truth" is not subjective. Compare listing a food's ingredients, for example, with determining whether that food can be called "organic." The SEC has rules that speak to the former; the "Names Rule" generally requires that if a fund's name suggests a particular type of

investment, industry, or geographic focus, at least 80 percent of the fund's assets must be invested consistently with the name. This rule, however, does not apply to the more-subjective terms describing a fund's investment objective, strategy, or policies. For such terms as "growth" or "value," an investor must dig deeper than the name to understand the fund's investments.

The SEC sought comment on the Names Rule in 2020, and Gensler has recently suggested that the SEC staff take a "holistic" look at it. But the SEC should not define criteria that must be met before funds can use marketing terms related to strategies — specifically of the ESG variety.

Despite its own inappropriate marketing push for investors to try ESG funds, the SEC is not — and should not be — in the business of deciding what is good for the environment and society. Where there is little agreement about what is and what is not green — see, for example, the current debates in the European Union about how to classify natural gas and nuclear energy for sustainability purposes — any definition necessarily results in the SEC's choosing winners and losers. This problem is exacerbated by the fact that there are trade-offs among the E, S, and G in ESG policy.

Letting the markets sort out different conceptions of sustainability based on what investors want is a far better course of action. This private ordering may not create a neat or clean solution, but that's to be expected when there's nothing neat or clean about defining what is environmentally friendly or socially desirable.

None of this is to suggest that investors should be misled about the strategy that their investment follows. The SEC can combat some greenwashing by enforcing rules already on its books that govern how investment advisers and investment funds communicate with their investors, including anti-fraud rules. Taking regulatory action to ensure that advisers and funds act consistently with their disclosed strategies and objectives is generally uncontroversial and can be particularly important where investors are paying higher management fees for ESG investments. The SEC has already been busy on this front: In the last year, the agency formed a task force, launched at least two reviews of asset-manager practices, and issued a risk alert. Whether some sort of additional disclosure by fund managers about their strategies can help investors is highly dependent on the disclosure required, but it's important to not view disclosure (which has its own costs) as a panacea.

Greenwashing is best combatted by the continued development of voluntary and private structures that help to define the term "green" for different investors and provide discipline that subjects funds to reputational harm when they advertise themselves as green without reason. In the end, it's better to let "green" get twisted a bit by the Name Game if it means that it can be more responsive to diverse or changing ideas about what it means to be sustainable.

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