PGIM

ESG

PGIM POLICY INSIGHTS: IMPROVING THE SFDR

APRIL 2024

INTRODUCTION

Sustainable finance initiatives, including investor disclosure, can play a limited but important role in mitigating the negative impacts of certain economic activities on our environment and society. The Sustainable Finance Disclosure Regulation (SFDR) has carved a new path by requiring ESG disclosure for asset managers. The investor community has developed further awareness around sustainability which is positive. That said, the SFDR has not addressed concerns of greenwashing and may, in some aspects, have worked against this goal. There is room to enhance this legislative framework to better enable investors to develop greater sophistication and investment managers to help finance the real-economy's transition to net zero. PGIM[1], a leading global asset manager, supports the European Commission's efforts to seize this important opportunity for the SFDR to unlock its full potential.

TO LABEL OR NOT TO LABEL, THAT IS THE QUESTION

Seemingly, we are at a crossroads with two paths to choose from. Should SFDR continue on its current path as a product disclosure regime? Or, given that the market has treated the existing disclosure framework as a labelling regime, should SFDR abandon the current track and choose a path towards fund categories? PGIM advocates for a third path: embed meaningful investor disclosure by addressing deficiencies in the current Article 8/9 framework while introducing a voluntary categorisation regime that functions well across a broad range of asset classes.

1 PGIM is the global asset management business of Prudential Financial, Inc with $1.3T in AUM, 1,450+ investment professionals and 47 global offices. Our businesses have deep asset class expertise in fixed-income, liquid and illiquid alternatives and fundamental equity. PGIM has offices in 10 European countries, portfolio managers across the region and a broad European investor base.

DISCLOSURE DYSTOPIA

Before simply casting the existing disclosure regime onto the scrapheap, we should explore why it has not functioned as intended and consider improvements. Reform of the disclosure regime should seek to address its complexity, its lack of clear definitions and its excessive focus on comparability rather than transparency. The amount and density of information included in the disclosure templates today is overwhelming, with minimal value to investors. It has reduced investor due diligence on ESG claims. When faced with a tangled hedge maze of information, investors disengage and seek a simple answer: is this 'Article 8' or 'Article 9'? Disclosure can be simplified to allow investors to better engage with information and make informed choices. Policymakers could consider streamlining disclosure in the following ways:

- **Combine Articles 8 and 9** to create a single disclosure provision for products that make sustainability claims. This would ease administrative burden for firms and create a clear distinction between products with sustainability objectives and those without.
- **Within a common disclosure framework, allow to tailor disclosure to the product in question.** Disclosure requirements should seek to highlight a product's unique characteristics, sustainability objective, and strategy, including any key performance indicators (KPIs) that are material to implementing the investment strategy. Any metrics-based structure that allows for comparison between products should allow for explanation of how these metrics apply (or not) to the strategy of the product.
- **Clarity over comparability.** Predefined mandatory indicators (e.g. PAIs and Taxonomy alignment), binary concepts (e.g. sustainable or not), and overlapping concepts (Taxonomy/ SFDR Art 2(17) definitions) emphasise comparability over transparency. Focus should shift to ensuring disclosures of KPIs that are actually used for the strategy in question and why these are most appropriate for the sustainability objective for said product.

We envision a uniform disclosure framework – i.e. a table with standard fields – but allowing product manufacturers to fill in the fields that are relevant to them and explain how they fulfil provisions in these fields. Manufacturers should also have the ability to explain why certain fields are not relevant for the product in question. Such a redesigned and streamlined disclosure framework should reengage investors. It would allow them to better understand sustainability claims and carry out their own effective due diligence. We hope that such a streamlined regime would smooth the path for appropriate scrutiny of disclosures by a broad range of stakeholders. The complexity of the current regime makes it taxing to audit and probe sustainability claims in a meaningful way. Ultimately, investors will be able to make informed comparisons when they have comprehension of products' sustainability claims.

CATEGORIES – THE GOLDILOCKS FRAMEWORK?

There is merit in exploring a voluntary categorisation or labelling regime for sustainable investment products. A well-crafted system could guide investors to making informed decisions and compare products more easily. The design of such a system is critical to its success.

If product categories are too narrowly defined, they will not function across a wide range of asset classes, strategies and products, nor will they reflect the needs of product manufacturers, funds distributors and consumers. Likewise, if product categories/ labels are too broadly defined and minimum eligibility criteria are too lenient, they will give the impression of creating robust "standards," without actually doing so (similar to Article 8 today). This would discourage due diligence and potentially lead to more greenwashing in the market. The 'Goldilocks' labelling regime is therefore a careful balance.

If a categorisation regime is to be pursued, we advocate the following:

- **Voluntary:** Any supplementary product categorisation system should be voluntary in nature.
- **Road testing is critical:** The Commission should conduct consumer testing using real-world distribution channels to inform the design of the categorisation system. Requirements should be tested across a broad range of asset classes and strategies to ensure they reflect the needs of both product manufacturers and consumers.
- **Double materiality:** Categories should be based on a double-materiality approach to make sure that only strategies focused explicitly on contributing to environmental and social sustainability are eligible for product categories with sustainability claims. The current disconnect between some Article 8 products' ESG methodology being narrowly focused on reducing financially-material ESG investment risks, and end investors' ESG expectations being focused on proactively promoting environmental/social sustainability, has contributed to greenwashing concerns.
- **Agnostic to implementation strategy:** Categories should relate to the clearly articulated sustainability objectives (i.e., what the product is seeking to achieve) rather than the tools used to implement its sustainability strategy. Products with similar sustainability objectives (e.g., "transition focus") may employ different strategies, data, KPIs, or tools such as exclusions or engagement, in order to seek to achieve those objectives. The categorisation system should be agnostic as to the strategies used to achieve the sustainability objective aligned with a given category.
- **Avoid fragmentation:** Product categorisation system requires full harmonization at the EU level. Such a system will not work if there are divergent requirements for the same label across Member States.
- **The MiFID 2** sustainability preferences and suitability requirements should accommodate products that may fall outside the categorisation system.

CATEGORISE, BUT NOT CATEGORICALLY

Finally, there will inevitably be products that fall outside the defined product categories. This is why a voluntary labelling regime must sit alongside a disclosure regime that can cater for such products. This is an essential piece of the puzzle as the SFDR needs to accommodate the varied needs and preferences of investors within the EU and to promote innovation. In essence, any product categorisation regime should be combined with a streamlined disclosure regime to be effective and allow for a variety of sustainability strategies to find their way to the market. It is a careful balance. But such a system, if well crafted, could underpin rigorous investor due diligence and simultaneously make it simpler and more consumer-friendly.

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