Proskauer

Sustainability Under the Microscope: ESMA's Reality Check

Regulatory & Compliance on **July 31, 2025**

On the 30 June 2025, the European Securities and Markets Authority ("**ESMA**") published its final report on the 2023–2024 Common Supervisory Action ("**CSA**") on the integration of sustainability risks and disclosures. This initiative, conducted in collaboration with the European Economic Area's national competent authorities ("**NCAs**"), focused on assessing compliance with the Sustainable Finance Disclosure Regulation ("**SFDR**"), Alternative Investment Fund Managers Directive, and the UCITS Directive.

The findings, which we summarise here alongside some useful good and poor practice examples, offer useful insights and supervisory expectations for asset managers navigating SFDR's disclosures.

Supervisory Focus and Scope

The CSA reviewed asset managers' approach to integrating sustainability risks, the quality of their disclosures on the integration and the likely impact at both entity and product levels.

The key areas of assessment included:

- governance and risk management frameworks for sustainability risks;
- consistency and clarity of SFDR disclosures;
- alignment of remuneration policies with sustainability objectives; and
- mitigation of greenwashing risks.

Integration of Sustainability Risks

ESMA determined that most asset managers demonstrated a baseline level of compliance with sustainability risks integrated into governance structures and investment processes. However, ESMA also identified several areas for improvement:

- **Policy Gaps**: Some managers lacked documented procedures or escalation mechanisms for sustainability breaches.

- **Resource Constraints**: Smaller firms often had limited dedicated ESG personnel, while larger firms showed more structured ESG integration.
- **Data and Methodology**: Inconsistent use of ESG data and limited verification of third-party sources were common.

ESMA emphasised the need for robust internal controls, regular policy updates, and clear delineation of responsibilities across compliance, risk, and investment functions to support with the improvement of the integration of sustainability risks.

Entity-Level Disclosures

ESMA highlighted mixed quality in entity-level SFDR disclosures in its CSA:

- **Principal Adverse Impact (PAI) Statements:** Many lacked detail or failed to explain non-consideration adequately.
- **Remuneration Policies:** Several managers did not clearly link ESG performance to variable pay or failed to publish relevant information on their own websites.
- **Greenwashing Risk Management:** While most firms acknowledged greenwashing risks, confusion between sustainability-related risks and greenwashing risks persisted.

ESMA recommends that asset managers enhance transparency, ensure disclosures are easily accessible, and align internal policies with public statements to support with improving entity-level disclosures.

Product-Level Disclosures

At the product level, ESMA found significant variability in how sustainability objectives and methodologies were disclosed:

- **Inconsistent Use of ESG Terminology:** Some Article 6 funds used ESG-related names or imagery, raising greenwashing concerns.
- **DNSH and Good Governance:** Many managers did not adequately demonstrate how investments met the “Do No Significant Harm” (“**DNSH**”) principle and/or good governance criteria, as relevant to a particular fund.
- **Sustainable Investment Thresholds:** Discrepancies between committed and actual sustainable investment levels were noted.

Asset managers are urged by ESMA to ensure that disclosures are not only compliant but also meaningful and reflective of actual investment practices.

Regulatory Follow-Up and Enforcement Outlook

The NCAs were asked to report on the follow-up actions they plan to take following the CSA exercise. The majority considered that there was an overall satisfactory level of compliance among managers and most of the vulnerabilities identified were addressed before the end of the period of the CSA.

As part of this process:

- many NCAs issued bilateral letters to managers outlining specific areas for improvement;
- others took more formal steps, including supervisory orders, warning notices, or risk mitigation programmes; and
- follow-up actions focused particularly on issues such as the incorrect use of fund names, suggestive non-textual imagery, and incomplete or missing disclosures.

Most NCAs expect these shortcomings to be resolved in the coming weeks or months. Only one NCA reported having taken enforcement action, while another indicated that enforcement was under consideration. The prevailing view among NCAs is that escalated supervisory measures are more effective than enforcement in addressing the identified breaches.

Below are examples outlining key areas of what ESMA considers to be good and bad practice with respect to sustainability risks, both in their practical integration and disclosures:

Good Practice

1. Policies and Procedures on the Integration of Sustainability Risks

A fund establishes clear screening criteria and exclusion lists which are reviewed at least annually. If the portfolio becomes overly exposed to unabated fossil fuels, the manager identifies the risk and proactively rebalances the portfolio by reallocating investments to less vulnerable sectors.

2. Integration of Sustainability Risks in Risk Management Procedures

The risk management framework incorporates ESG scores into existing metrics to assess the overall risk profile of the funds and portfolios under management.

If a portfolio exhibits elevated ESG risk over two consecutive quarters, the manager evaluates appropriate corrective measures to enhance the fund's ESG profile over the long term.

3. Engagement Policies

One manager's PAI statement includes a detailed explanation of how its engagement policies will be adjusted in cases where no reduction in principal adverse impacts is observed over multiple reporting periods. This reflects a proactive and ambitious engagement strategy, as envisaged under Article 8(2)(b) of the SFDR Delegated Regulation.

4. Designation of Sustainability Characteristics or Objectives

The manager clearly identifies the fund's promoted characteristics and objectives in its financial product disclosures, aligning them with recognised classifications such as specific sub-objectives under the UN Sustainable Development Goals ("**SDGs**"), the environmental objectives outlined in Article 9 of the Taxonomy Regulation, and the social objectives proposed in the February 2022 report by the Platform on Sustainable Finance on a social taxonomy.

5. Good Governance

The manager conducted a governance screening using clearly defined criteria and principles to determine whether a company should be excluded or retained in the portfolio when a controversy arises, both at the point of investment and through ongoing monitoring. The procedures implemented for funds disclosing under Article 8 of the SFDR were deemed sufficient to ensure that investee companies adhere to good governance practices.

Below Average / Noncompliance

1. Senior Management's Skills and Expertise

Senior management lacks sufficient resources and expertise to effectively integrate sustainability risks and does not possess a demonstrable track record in sustainability supported by appropriate training.

2. Failure to Disclose Reduction of Carbon Emissions Aligned with the Paris Agreement

One manager assesses the principal adverse impacts (PAIs) of its investment decisions on sustainability factors but does not reference the extent to which these align with the objectives of the Paris Agreement, despite employing a dedicated risk assessment tool to evaluate decarbonisation pathways at both asset and portfolio levels. In accordance with Article 4(2)(d) of the SFDR, the manager should provide a clear indication of how its investment strategy aligns with the Paris Agreement's goals.

3. Good Governance Criteria

The processes implemented by managers for Article 8 SFDR funds were insufficient to ensure that investee companies adhered to good governance practices. While some level of screening was in place, there were no clearly defined timeframes or materiality thresholds to determine how long engagement with non-compliant companies could continue before exclusion from the investment universe. Under Article 8 of the SFDR, such governance standards must be upheld regardless of whether the fund qualifies as a sustainable investment.

4. Inconsistency Between Marketing Material and Pre-Contractual Disclosures

A manager disclosed inconsistent information between a fund's marketing materials and its pre-contractual documentation. While the marketing materials featured various logos and visual elements — some referencing the UN SDGs — they did not reflect any corresponding commitments or characteristics in the fund's pre-contractual disclosures. This discrepancy contravenes Article 13 of the SFDR, which requires that marketing communications must not contradict the information provided under SFDR disclosures.

5. Identification of Excessive Numbers of Characteristics and Objectives

In its pre-contractual disclosures, a fund claims to promote all of the UN SDGs as part of its sustainability characteristics. However, in subsequent periodic disclosures, it reports contributions to only one or two of those goals. This approach does not provide meaningful guidance to investors regarding the fund's investment strategy and may instead allow for retrospective justification of investments by loosely associating them with broad sustainability objectives.

What can asset managers do to address these potential risks?

The CSA has underscored the importance of credible, transparent, and verifiable sustainability practices in asset management and again put managers on alert that NCAs are actively supervising SFDR's requirements and broader sustainability-related claims.

For further information, please reach out to ukreg@proskauer.com.

View original.

Related Professionals

- **John Verwey**
  Partner
- **Rachel E. Lowe**
  Partner
- **Sulaiman I. Malik**
  Associate
- **Michael Singh**
  Associate