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Compliance Update

SFDR Update: A Step Up in Scrutiny

By Ruth Knox

In recent weeks, EU regulators have issued several updates clearly indicating that, while the Sustainable Finance Disclosure Regulation (SFDR) remains subject to review and likely substantial revision at the end of 2025, enforcement authorities will be stepping up their scrutiny of asset managers that market in-scope financial products to European investors over the coming months.

This composite update summarises the key recent developments and their likely consequences for asset managers.

ESMA 2023-2024 Final Report on the Integration of Sustainability Risks and Disclosures

Following the launch of the Common Supervisory Action (CSA) with National Competent Authorities (NCAs) in July 2023 to supervise the integration of sustainability risks and disclosures, the European Securities and Markets Authority's (ESMA) issued a report on 30 June 2025, setting out its views on whether market participants are adhering to the SFDR and related AIFMD and UCITS rules on integrating sustainability risks into investment processes. The ESMA concluded "there is room for improvement" in the level of managers' compliance with the frameworks. It identified "several vulnerabilities", particularly with respect to compliance with the SFDR, and it encouraged the NCAs to "continue proactive engagement with market participants and follow up with those cases where vulnerabilities were detected, including enforcement, where appropriate" and even invited them "**to use their enforcement powers if and when appropriate in case of regulatory breaches**".

To perform the CSA, NCAs used a desktop review complemented by on-site visits to either the whole or part of the sample of supervised entities. A few NCAs also requested additional data during these on-site inspections, particularly regarding the underlying investments of funds disclosing under Article 9 of the SFDR, including the criteria used to determine if companies fail the "Do No Significant Harm" (DNSH) test for sustainable investments. Supervision was also conducted through the issuance of bilateral letters outlining specific areas for improvements, while other NCAs issued supervisory orders, warning notices or risk mitigation programmes. Interestingly, one NCA challenged misalignments by using a proprietary ESG dashboard tool that combined an assessment of the precontractual disclosures for a fund against its latest submitted portfolio.

Vulnerabilities identified in respect of SFDR compliance included:

1. Overly general and vague SFDR disclosures, missing data or inconsistencies across precontractual, periodic, website disclosures and marketing materials.

2. Vague descriptions of how the Principal Adverse Impacts (PAIs) were taken into account at the entity level.

3. Lack of documented policies on the consideration of sustainability risks and lack of escalation procedures in the case of a breach of the policies.

4. Low numbers of dedicated sustainability professionals or poor knowledge of sustainability matters.

5. Lack of specific criteria on the consideration of sustainability risk in remuneration policies.

6. Lack of controls and processes to ensure the description of the fund's sustainability strategies is substantiated by ESG metrics/data or consistent with promoted environmental and/or social characteristics and good governance principles.

7. Lack of verification or review of data from third parties or information obtained by an ESG provider.

8. Lack of audit of the implementation of internal policies.

NCAs identified some confusion that resulted in certain managers treating greenwashing risks and sustainability risks as the same type of risk. NCAs emphasised **the importance of clear definitions of greenwashing risk within managers' policies along with robust policies to identify and address conflicts of interest arising from greenwashing**. This risk arises in part because of the halo effect from green or ESG-related marketing in the European market.

Good practices identified included:

1. A manager considering actions to improve the ESG profile of a fund over the long-term when the portfolio had been identified as comprising high ESG risk for two consecutive quarters.

2. Regular review of the information published on the manager's website.

3. The names of funds generally reflecting their ESG or sustainability-related characteristics or objectives.

4. Managers conveying good governance through adoption of principles and binding policies such as codes of ethics, whistleblower policies or supplier codes of conduct.

5. Classification of social objectives based on the February 2022 report by the Platform on Sustainable Finance on the social taxonomy.

Below average practices identified included:

1. An ESG manager with one year of experience obtained through trainings and seminars with no proven track record linked to sustainability.

2. Information on remuneration policies containing vague or principles-based content.

3. A fund disclosing under Article 9 that invests in green, social and sustainability bonds finding that the issuers of those bonds failed to share enough information, preventing the fund from performing a DNSH analysis.

4. Managers changing the form of the prescribed templates.

5. Poor quality explanations on nonconsideration of PAIs, e.g., lack of available market information and lack of reasonably priced and readily available data.

6. Managers identifying too many characteristics or objectives.

7. Article 8 funds with no processes to assess good governance.

On Article 9 diligence, ESMA helpfully notes that "the high level of variety in the evaluation of sustainable investment … can partly be explained by a lack of clarity and detail and the resulting degree of discretion in existing regulatory requirements", and that "the growing body of Q&As provided by the ESAs" aims to provide further guidance where the underlying regulation is unclear. Another helpful point is the explicit recognition by ESMA that "the current SFDR framework" does not require "disclosure of any specific thresholds or other criteria for assessing the sustainable investments' contribution and DNSH tests". Nevertheless, where data on the DNSH analysis is not available, managers **must** seek to obtain the data directly from investee companies, carry out additional research, cooperate with third party data providers or external experts, or make reasonable assumptions.

Finally, ESMA notes that NCAs should encourage entities to "avoid overly general references to SDGs for sustainable investments' contribution to sustainability objectives in order to ensure that disclosures are fair, clear and not misleading."

ESMA Thematic Notes on Clear, Fair and Not Misleading Sustainability-Related Claims

This note, issued on 1 July 2025, is the first of a series of thematic notes prepared for asset managers to educate them on sustainability-related claims.

In particular, it flags that:

1. Asset managers must communicate sustainability information in line with the long-established principle of "fair, clear and not misleading information".

2. Sustainability claims are made by participants across the "Sustainable Investment Value Chain" — including issuers, fund managers, benchmark administrators and investment service providers. Asset managers should consider the full ecosystem in which their claims are socialised as part of compliance strategies.

3. Misleading claims can take the form of cherry-picking, exaggeration, omission, vagueness, inconsistency, lack of meaningful comparisons or thresholds, and misleading imagery or sounds.

4. Regulatory information comprises fund or bond prospectuses, management reports, funds' KIDs and benchmark statements, while nonregulatory information comprises other materials such as marketing materials or voluntary reporting.

5. The key four principles to follow are that sustainability-related claims should be:

    1. Accurate: In particular, claims should steer clear of vagueness and excessive references to irrelevant or non-binding information.

    2. Accessible: Claims should not be oversimplistic but made with an appropriate level of detail so that they are easy to understand. Further substantiation "can be … presented to the reader in layers … ensuring substantiation is easy to find" so as not to overwhelm the reader.

    3. Substantiated: Claims should be based on methodologies that are fair, proportionate and meaningful.

    4. Up to date: There should be controls that check for compliance with the marketed criteria over time.

Interestingly, ESMA flags the risks associated with marketing ESG-related awards that may not carry significance in practice. In addition, ESMA calls out references to SFDR designations as credentials as a bad practice, as well as the use of the phrase "Art.8/Art.9 SFDR-compliant".

Enhanced Scrutiny by the Danish FSA

Emerging as one of the most prominent NCAs in issuing improvement orders under the SFDR, the Danish Financial Supervisory Authority (FSA) has stepped up risk-based scrutiny of investors' **governance and internal procedures** on sustainability risk management and the approach taken by managers to making sustainable investments. The primary focus for such scrutiny is on retail products — given professional investors tend to understand complex regulation better — as well as asset managers making more ambitious sustainability-related claims, due to the greater level of trust placed in them. While other NCAs could take a different approach to enforcement of the SFDR, the thematic reviews issued by the FSA have provided helpful guidance to the market:

- One manager's method for measuring contribution to an environmental objective was based on the investee companies' intentions to reduce greenhouse gases in the long term rather than the companies' actual reductions, creating a risk that the product did not contribute to an environmental objective.

- Companies need to have methods and documented processes to ensure respect for good governance practices.

- One asset manager did not have sufficiently robust processes in place to measure alignment with the UN Declaration of Human Rights and ILO Declaration on Fundamental Principles and Rights at Work.

- There can still be room for some transition investments within Article 9 financial products where any harm done to environmental or social goals is not significant.

The FSA notices did not include penalties, but the relevant managers were told to rectify the issues identified. The FSA example serves as evidence of the movement away from a principles-based approach to enforcement of the SFDR.

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings London lawyer:

Ruth Knox
+44-20-3321-1085
ruthknox@paulhastings.com