ESMA Reports on Outcome of CSA on Sustainability Disclosures

Following a review of compliance with the framework on the integration of sustainability risks and disclosures, ESMA has published its report setting out its findings and providing specific recommendations to national competent authorities and market participants.

In July 2023, the European Securities and Markets Authority ("**ESMA**") launched a common supervisory action ("**CSA**") with national competent authorities ("**NCAs**") on the integration of sustainability risks and disclosures in the investment fund sector. ESMA's aim in conducting the CSA was to assess and foster compliance of supervised entities with:

- the amendments to the directive on Undertakings in Collective Investment in Transferable Securities ("**UCITS Directive**") and the Alternative Investment Fund Managers Directive ("**AIFMD**") introducing measures on the integration of sustainability risks;
- the current regulatory framework under the Sustainable Finance Disclosure Regulation ("**SFDR**") including the financial product disclosure of the share of investments aligned with the criteria set out in the Taxonomy Regulation and related SFDR implementing measures; and
- the adherence to the principles of the ESMA supervisory briefing on sustainability risks and disclosures in the area of investment management, published in May 2022.

ESMA has now published its final report setting out its findings. Overall, ESMA has concluded that there is room for improvement in the level of fund managers' compliance with the framework. Despite the finding by the majority of NCAs that the overall level of compliance was satisfactory, several vulnerabilities were identified which were addressed as part of the review through bilateral letters and other supervisory orders. In addition to highlighting cases of non-compliance, good practices and below average practices, the report sets out ESMA's specific recommendations to NCAs and market participants.

Key Findings

The table below provides an overview of the main issues and vulnerabilities identified by NCAs during the review.

Disclosures	▪ Vague and overly general language, missing or inadequate details, difficult to locate disclosures and use of jargon. ▪ Inconsistencies between pre-contractual, periodic and website disclosures and marketing material. ▪ Environmental or social characteristics in the pre-contractual information were not clearly disclosed, making it unclear how the characteristics were measured and fulfilled.
Consideration of Principal Adverse Impacts (PAI)	▪ **PAI Statements at Entity Level:** inadequate level of details and unsatisfactory explanation of non-consideration, inconsistencies in the calculations ▪ **DNSH assessment for "sustainable investments":** all mandatory PAI indicators listed in Table 1 of Annex I to the SFDR Level 2 Regulation must be taken into account when carrying out the do no significant harm (DNSH) assessment to determine whether or not an investment is a "sustainable investment" within the meaning of the SFDR. Indicators from Table 1 of Annex I cannot be left out on the basis of insufficient or unreliable data
Integration of Sustainability Risks	▪ Lack of properly documented policies ensuring alignment of the relevant sustainability risks in the investment decision with the funds' investment strategies. ▪ Lack of escalation procedures in case of breach of policies. ▪ Lack of due diligence on how sustainability risks are integrated in the investment management process. ▪ Lack of description of sustainability indicators and the corresponding limits in the fund risk profile. ▪ Inadequacies in the frequency of reporting to senior management of board of directors. ▪ Room for improvement in how sustainability risks are taken into account for different types of assets such as cash, fixed-term deposits, structured products and derivative instruments. ▪ Article 6 funds must be considered in risk management processes. ▪ Sustainability risks and greenwashing risks are not to be treated as the same type of risk. Clear definitions of greenwashing risk within policies is important, along with robust procedures for identifying and managing conflicts related to greenwashing.
Resources	▪ Cases of low number of dedicated employees for sustainability tasks, or unsatisfactory knowledge of sustainability matters from the relevant employees. ▪ Training to enhance sustainability related skills should be delivered at a regular frequency and evidenced.
Remuneration Policies	▪ Lack of specific criteria and indicators to measure how remuneration policies are consistent with the integration of sustainability risk.
Controls and Processes in Place	▪ Lack of processes to ensure that the description of the funds' ESG strategies is substantiated by the ESG metrics / data used or is consistent with environmental and / or social characteristics and good governance principles. ▪ Internal control systems have been identified as an area of focus for ongoing supervision. In some cases, supervised entities did not integrate sustainability risks in the third level of control. The 2025 CSA on compliance and internal audit functions will provide NCAs with an opportunity to investigate this area further.
ESG Data	▪ Lack of verification or review process of data from third parties. ▪ Data sometimes incomplete or inaccurate.
Auditing System	▪ Lack of audit of the implementation of internal policies

Many NCAs have already issued bilateral letters to entities to ensure compliance and outline specific areas for improvement and have highlighted to ESMA that they have followed up or will follow up on the CSA's main findings (in particular those related to incorrect use of names, use of suggestive non-textual imagery and incomplete or missing disclosures). While ESMA acknowledges NCAs' general preference to use escalated supervisory measures instead of taking enforcement measures, it reiterates the importance of using the "full range of the supervisory and enforcement toolkit" available to NCAs. ESMA also notes that the ongoing review of SFDR Level 1 will not lead to changes in the near future and therefore NCAs should remain vigilant on the supervision of the current framework.

The Central Bank of Ireland has indicated that it will issue its own communication following the conclusion of the CSA and the publication of ESMA's report.

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