

Review

# The Legal Framework and Challenges of Sustainable Investment Funds in the European Union and Serbia

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**Abstract:** The research examined the legal and institutional framework of sustainable investment funds in the European Union and its relevance for the Serbia. A descriptive and analytical approach was applied, combining normative legal analysis with empirical data from European regulatory reports. The empirical basis of the study consists of secondary regulatory sources, analyzed through a descriptive and cross-sectional approach using desk research and content analysis. The findings indicate that the European Union has established a comprehensive regulatory system promoting the integration of sustainability principles into the financial sector; however, inconsistent methodologies and the lack of standardized ESG data continue to limit its effectiveness and transparency. The analysis revealed that funds promoting environmental and social characteristics constitute the majority of the market, while funds with sustainability as their primary investment objective represent only a small share of total assets. In Serbia, the process of alignment with EU sustainable finance standards is progressing gradually, yet without a fully developed infrastructure for ESG data verification and public disclosure. The study concludes that sustainable finance currently functions more as a regulatory framework than as a fully operational market practice. The scientific contribution of this paper lies in linking legal and empirical perspectives on sustainable finance, while the practical significance is reflected in highlighting the need for data standardization and institutional strengthening for effective ESG implementation.

**Keywords:** *Sustainable investment funds; ESG regulation; EU Taxonomy; legal framework.*

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## 1. Introduction

The development of sustainable finance over the past decade has shown that regulation alone is not sufficient to ensure a fundamental transformation of the financial system. Although investment funds have been designated as key instruments for the transition to a sustainable economy, it is still unclear how much the declared ESG - Environmental, Social, Governance principles are really integrated into their investment strategies. In practice, it was observed that many funds formally fulfill regulatory requirements, but without real impact on the environment and society, which opened up a dilemma about the border between legitimate promotion and the so-called. "greenwashing" [1,2].

The European Union tried to overcome these challenges by establishing an integrated normative system that includes the EU Taxonomy [3], SFDR [4] and the revised UCITS/AIFMD Directive [5,6]. However, despite formal harmonization, the issue of standardization and quality of ESG data is still disputed. Numerous studies have pointed to differences in the assessment of the sustainability of the same entities, depending on the applied methodology [7,8], which calls into question the transparency of the system. In 2023, the European Commission launched the European Single Access Point (ESAP) initiative for the centralized collection of ESG data, but the project is still under development [9].

In parallel with the normative development, the growth of the market of sustainable funds was recorded, which shows the increased interest of investors, but also the need for a clearer legal and methodological structure. This disparity between the regulatory framework and market practices raised the question of whether sustainable financing in the EU is primarily a legal concept or a functional market mechanism.

In the context of the Serbia, the process of harmonization with European standards is still ongoing. Although strategic documents, such as the RS Capital Market Development Strategy 2021–2026 [10], and the report of the Securities Commission [11], indicate the need to introduce ESG principles, national regulations still do not contain a systematic obligation to report on sustainability.

The aim of this research was to analyze the legal framework of sustainable investment funds in the European Union and assess its applicability in the context of the Serbia. The initial hypothesis was that the lack of standardized ESG data and methodological compliance limits the real transparency and market efficiency of sustainable funds, which is why the concept of sustainability in finance still predominantly manifested itself as a regulatory form rather than a fully functional market practice.

## 2. Theoretical and legal framework of sustainable investment funds

### 2.1. Evolution and institutionalization of sustainable investment funds

Investment funds represent the basic institutional framework of collective investment, through which investors' capital is directed into financial instruments according to the defined goal and risk [5]. Unlike traditional funds, sustainable funds include ESG factors in investment decisions [1]. In this way, a double return is realized - financial and socio-ecological, with a focus on long-term resilience and reduction of climate and reputational risks [12,13].

ESG criteria include three dimensions: environmental protection, social responsibility and corporate governance [9]. Different approaches - negative and positive "screening", impact investing, best-in-class - contribute to the diversification of the market, but make comparability of funds difficult [7]. Therefore, the European Union has developed a coherent regulatory framework that includes the EU Taxonomy [3], the Sustainable Finance Disclosure Regulation [4] and the revised UCITS/AIFMD Directives [5,6].

With these regulations, ESG factors move from conceptual guidelines to binding practice, whereby the EU establishes a single regulatory language for sustainable financing [14,15]. In research, Cardoso [16] indicates that the SFDR is not only a regulatory tool for investor protection, but also an instrument for harmonizing market practices across the EU.

The taxonomy classifies sustainable economic activities, the SFDR introduces the obligation to report on ESG risks and policies, and the UCITS/AIFMD aligns fund management with the fiduciary duties of managers [9]. The SFDR specifically distinguishes funds that only promote ESG features (Article 8) from those with sustainability as the main objective (Article 9), making the EU the reference framework for the institutionalization of ESG practices [17].

### 2.2. Global standards and challenges of ESG data transparency

The development of the concept of sustainable financing has global roots in the initiatives of the United Nations and the OECD. Principles for Responsible Investment (PRI) from 2006 and Agenda 2030 with Sustainable Development Goals (SDGs) from 2015 set the ethical framework for the

integration of ESG principles in the financial sector [12],[13]. These documents redefined the role of financial institutions - from passive investors to actors who contribute to the achievement of public and environmental goals.

The European Union has built on these initiatives by developing binding standards, which have become a global benchmark. The OECD, the G20 and the World Bank recommend harmonizing national regulations with the principles of the Taxonomy and the SFDR [18]. Thanks to such a framework, the EU today accounts for about 80% of the world's assets of ESG funds [19].

In the area of reporting, the initiatives Task Force on Climate-Related Financial Disclosures (TCFD), Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB) and International Sustainability Standards Board (ISSB), whose standards were supported by IOSCO in 2023 [7], play a key role. They link non-financial indicators with legal obligations and contribute to the global harmonization of data.

However, transparency still depends on the quality and consistency of ESG information. Non-uniform methodologies and differences in the approaches of rating agencies lead to divergent ratings [8], thereby reducing investor confidence and increasing the risk of "greenwashing" [2]. The EU is trying to overcome this through the European Single Access Point (ESAP) - a centralized platform for collecting and publishing ESG data [9]. Although the project is still ongoing, it is a key step towards standardization and verifiability of information.

Harmonization of methodologies, stricter control of reporting and development of ESAP represent the basis for a credible market of sustainable funds in the EU and candidate countries like Serbia. Only standardized and verifiable data can ensure legal predictability and investor confidence - the foundation of a truly sustainable financial system.

### 3. Legal framework in the European Union

#### 3.1. EU Taxonomy Regulation (2020/852) – definition of sustainable activities

The regulation on the taxonomy of sustainable activities [3] represents the basic pillar of the legislative framework for sustainable finance in the EU. It was adopted to build the Sustainable Finance Framework [20], with the aim of redirecting capital towards projects that contribute to sustainable development and climate neutrality.

The essence of this act is to establish a unique system of classification of economic activities that can be considered sustainable. The taxonomy defines criteria that determine whether an activity contributes to sustainability goals such as: mitigation and adaptation to climate change, sustainable use of resources, transition to a circular economy, pollution prevention and biodiversity protection [3].

According to Article 3, an activity is considered sustainable if it significantly contributes to at least one goal, does not cause significant harm to others, respects minimum management standards and meets technical criteria adopted by the Commission [21]. The taxonomy does not specify investment obligations, but provides a framework for classification and reporting, thereby strengthening legal certainty and preventing arbitrary labeling of funds as "green".

This act is the foundation of all subsequent EU regulations on sustainable finance, including the SFDR and the CSRD Directive, as it introduces a common language and transparent criteria for assessing sustainability. Thus, the Taxonomy functions as a regulatory axis for market standardization and prevention of "greenwashing".

#### 3.2. Sustainable Finance Disclosure Regulation (SFDR) - reporting obligations of funds

Regulation on publication of information on sustainable financing SFDR[4], constitutes the second key pillar of the European system of sustainable finance. While the Taxonomy defines what a sustainable activity is, the SFDR prescribes how financial entities must report on the sustainability of their investments.

The SFDR obliges investment funds, managers and advisers to publish information on how in their investment processes they take into account sustainability risks, the impact of decisions on ESG

factors (Principal Adverse Impacts), as well as the category of the fund according to Article 6, 8 or 9 of the regulation[4].

Funds subject to Article 6 do not integrate sustainability as an objective, while Article 8 includes those that promote environmental and social characteristics, and Article 9 those with sustainability as the main investment objective. This classification has become a key instrument of market transparency and standardization, as it allows investors comparability of data and the level of ambition of the fund in terms of ESG criteria.

The SFDR requires the publication of information in fund prospectuses, periodic reports and on the websites of management companies. This ensures the continuity of transparency, while supervision over implementation is performed by ESMA, in cooperation with EBA and EIOPA through Regulatory Technical Standards [22].

Despite the contribution to standardization, differences in the interpretation of the term "sustainability" and unevenness between member states have emerged in practice. Therefore, the SFDR was subsequently linked to the Taxonomy, in order to ensure consistency and reduce the risk of mislabelling funds [23].

### *3.3. UCITS and AIFMD – integration of ESG principles into the existing framework of funds*

The UCITS [5] and AIFMD [6] directives represent the basis of the collective investment legal system in the EU. The first regulates funds available to small investors, and the second regulates alternative funds for professional investors.

In order to harmonize with the SFDR and the Taxonomy, both directives were supplemented in 2021 with Delegated Regulations that introduce the obligation to integrate sustainability risks into risk management and investment decision-making [24][25]. Thus, ESG principles become an integral part of the corporate fund management process, and not an additional regulatory element.

Fund managers are obliged to recognize ESG risks, adapt internal control policies and ensure transparent reporting to investors. UCITS and AIFMD thereby ensure the legal coherence of various EU instruments, and ESMA supervises their implementation at the level of member states.

This integration has a double significance: it strengthens the protection of investors through mandatory consideration of ESG factors and establishes a single standard of corporate responsibility in the financial sector. This creates a regulatory framework in which sustainability becomes a measure of good governance, not just an ethical add-on.

In conclusion, the legal framework of the European Union constitutes a coherent system in which each act has a precise function: the EU Taxonomy defines sustainable activities, the SFDR standardizes reporting and transparency, while UCITS and AIFMD integrate ESG principles into fund management practices. This multi-layered system not only aligns the financial sector with the goals of sustainable development, but also ensures legal predictability, prevents "greenwashing" and strengthens investor confidence in sustainable investment products.

## **4. Legal framework in the Serbia**

### *4.1. Legislative framework and harmonization with European Union law*

The regulation of investment funds in the Serbia is based on a combination of legal and regulatory acts that regulate the legal position of funds, business conditions and investor protection. Although the normative framework has been significantly improved in recent years, the field of sustainable investment funds remains largely unregulated at the systemic level, but is developing through gradual harmonization with the European Union regulations. The initial normative framework in the field of collective investment in the Serbia was established in 2006 with the adoption of the Law on Investment Funds of the RS [26], which defined the types of funds, conditions for the work of management companies and the competences of the Securities Commission (KHOV). However, the law did not contain explicitly established provisions on ESG principles or the obligation to integrate sustainability factors into investment processes. This law was the basis for the subsequent

development of specialized regulations and regulations on investment funds, which gradually harmonize the domestic system with the standards of the European Union.

The Capital Market Development Strategy of RS 2021–2026 [27] envisages gradual harmonization with EU regulations on sustainable financing (Taxonomy, SFDR, AIFMD, UCITS), but these acts have not yet been transposed into domestic legislation. In practice, there is no obligation for funds to publish ESG data, nor a clear methodology for assessing the sustainability of investments.

The Commission for Securities in its reports [11] emphasizes the need to introduce the principles of sustainable financing into the regulatory framework and practice. Similarly, the National Bank of Serbia through the Green Agenda for the Western Balkans and the Regional Action Plan for Sustainable Finance [28] supports the harmonization of domestic regulations with EU standards. Such initiatives indicate a gradual institutional readiness for normative adaptation, either through changes to existing laws, or through the adoption of a special law on sustainable financing.

#### 4.2. Challenges and gaps in legal regulation

The main challenges of developing sustainable funds in Serbia relate to:

1. lack of legal definition of sustainable investment, because the legislation does not know ESG terminology or technical criteria;
2. uniformity of reporting and lack of standards, because funds are not obliged to publish data on sustainability; and
3. limited capacities of supervisory bodies, considering that KHOV does not have explicit powers to supervise ESG reporting.

An additional problem is the small size of the domestic capital market, with a limited number of active funds. Nevertheless, positive trends are emerging — some companies include sustainability in their corporate reports, and the banking sector is gradually developing green credit products, creating the basis for the future introduction of ESG funds.

The current approach can be assessed as programmatic and not imperative: there are strategic documents and recommendations, but no binding norms. Such a situation makes legal predictability difficult and prevents effective supervision, because ESG obligations remain declarative and without a sanctioning mechanism.

In conclusion, the legal framework of investment funds in Serbia is in a phase of transition. Although there is no explicit regulation on sustainable funds, the existing legislative base and strategic initiatives create a basis for their future introduction. Serbia is at the beginning of the process in which ESG principles will become an integral part of the national legal system — a prerequisite for greater transparency, investor protection and the development of a sustainable capital market.

### 5. Challenges and legal problems of sustainable funds

The development of sustainable investment funds, despite the strong European framework, faced a number of legal and practical obstacles: uneven understanding of sustainability, differences in the application of regulations, the absence of globally harmonized standards and the pronounced risk of "greenwashing". In countries in transition, such as Serbia, these challenges were exacerbated by modest institutional capacities and a lack of mechanisms to verify ESG claims.

Although the EU Taxonomy and the SFDR introduce common definitions, practice has shown varying interpretations and requirements among member states [20], which increased legal uncertainty, especially for cross-border funds. Outside the EU, fragmentation was more pronounced (different frameworks in the USA, Japan, Canada). The experiences of the region indicated that the pace of implementation depends on the maturity of the market: e.g. Croatia operationally implemented the SFDR through the regulations of HANFA [29], while Poland applied a phased

approach through the guidelines of the supervisory body [30]. These models are useful for Serbia because they enable gradual harmonization without assuming all obligations at once.

Greenwashing remained a central legal risk. In the absence of consistent verification mechanisms, funds sometimes used general marketing claims (eco-friendly, impact, green focus) without a demonstrable contribution to sustainability [22]. Such practice exposed managers to potential liability based on misleading advertising and unfair business practices [31]. In 2023, ESMA launched coordinated supervisory activities specifically to tighten labeling and disclosure standards [32]. At the same time, part of the literature pointed to the conceptual "elasticity" of terms such as "sustainable activity" and "significant contribution", which allows flexibility, but also room for abuse [1].

Regulators and market participants often lacked sufficient capacity for complex ESG requirements. In Serbia, there was a lack of specialized departments and interdisciplinary skills in the supervisory bodies [28], which made it difficult to verify the statements from the fund reports and reduced the effectiveness of control.

The transparency of sustainable funds largely depends on the quality and comparability of data, and currently there is no single methodological framework for measuring the impact of investments on ESG factors, which makes it difficult to assess the real sustainability of funds. The EU is trying to overcome this by introducing the European Single Access Point (ESAP) platform for centralized collection and publication of ESG data, but the project is still under development [33].

Without reliable and standardized data, investors cannot make informed decisions, and the regulatory system remains vulnerable to manipulation. Empirical indicators on the structure and movement of capital within the market of sustainable funds additionally illuminate the effects of the application of the European regulatory framework. Based on data from ESMA[20] and ALFI[34], the main trends and quantitative changes in the period 2019–2023 are presented below.

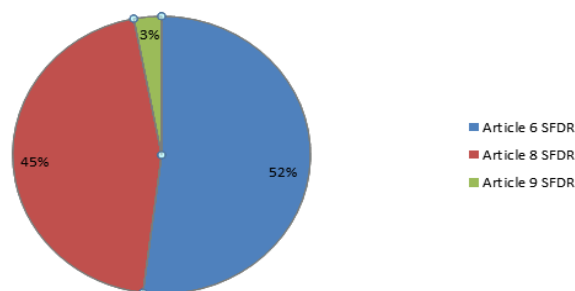
In addition to the quantitative growth of the number of funds, the sustainable investment market in the European Union is also characterized by a specific asset structure based on the classification according to the provisions of the SFDR.

According to ALFI data [34], the total assets of European sustainable funds grew from less than 1 trillion euros at the end of 2019 to around 2.2 trillion euros at the end of 2023, which represents a more than double growth in a period of five years.

This growth clearly shows that sustainable investing is becoming a significant segment of the financial market, with the growing participation of institutional investors and the increasing importance of regulatory support through the SFDR and the EU Taxonomy.

According to ESMA data [20], more than half of the total assets of UCITS funds (about 52%) are in funds that promote environmental and social characteristics (Article 8 SFDR), while funds with sustainability as the primary investment objective (Article 9 SFDR) make up about 3% of total assets.

The remaining part of the market (about 45%) includes funds that do not meet ESG criteria, that is, funds classified according to Article 6 of the SFDR.



**Figure 2.** Share of UCITS fund assets by SFDR classification [20].

This market structure shows that, although funds that promote sustainable features (Article 8 SFDR) take a dominant share of total assets, a relatively small percentage of funds with strictly

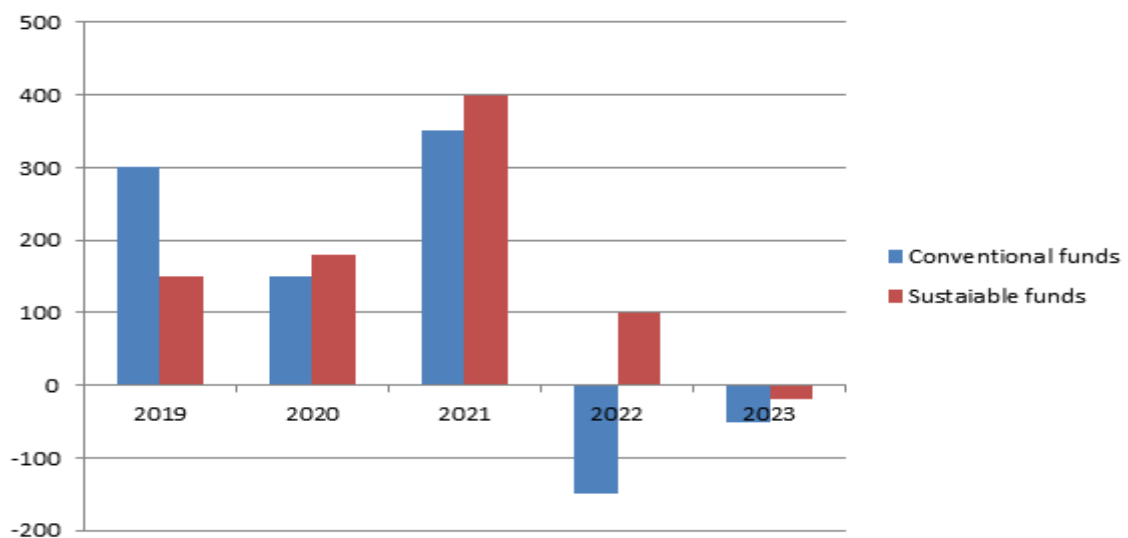
defined sustainable goals (Article 9 SFDR) indicates a limited scope of the "dark green" segment of the market.

This confirms that the European market of sustainable funds is still in the phase of transition from a promotional to a fundamentally sustainable investment model, which highlights the need for additional regulatory clarification and stronger monitoring of the credibility of published ESG claims.

Analysis of net capital inflows further sheds light on investor confidence in sustainable funds.

While the ESMA TRV 2023 shows the legal structure of the market according to the provisions of the SFDR, data from ALFI [32] reveal that funds with ESG characteristics have recorded a continuous growth of capital flows in the period 2019–2023. year.

Even in periods of market instability, sustainable funds have attracted new investments, which confirms that regulatory stability and transparency have a direct impact on investor confidence.



**Figure 3.** Net capital flows into European funds (2019–2023).

The presented trend of net flows confirms that sustainable funds are not only a regulatory phenomenon, but also a market driver.

While Chart 2 shows how sustainability has been formally integrated into the European legal framework, Chart 3 illustrates how investors have responded to that institutionalization — by diverting capital into funds that meet SFDR criteria.

This relationship between legal structure and market behavior confirms the complementarity of the regulatory and economic aspects of sustainable finance.

The dynamic growth and changed structure of the market of sustainable funds in the European Union required the development of a specific regulatory framework, which unites legal acts of different levels - from primary regulation to sectoral guidelines.

The following table shows an overview of the most important European and domestic regulations that shape the legal framework of sustainable investment, with special reference to their substantive role and the current status of implementation in the Serbia.

**Table 1.** Overview of Key EU and National Regulations in the Area of Sustainable Investment.

Regulatory Area	EU Framework	Status in Serbia	Remarks
Activity Classification	EU Taxonomy (2020/852)	Not adopted	Harmonization plan in place (2026)
ESG Disclosure and Reporting	SFDR (2019/2088)	Not implemented	Planned under the Capital Market Development Strategy 2021–2026
Integration of ESG Risks	UCITS/AIFMD Amendments (2021)	Partially present ( <u>KHOV- Securities Commission of the Republic of Serbia guidelines</u> )	Requires statutory support
Supervision and Oversight	ESMA/EBA/EIOPA Supervision	Limited capacity of KHOV	No specific sanctioning mechanisms

The presented overview indicates that the legal framework in the Serbia is still in the phase of adaptation to European standards.

While EU regulations - such as the Taxonomy, the SFDR and the amendments to the UCITS/AIFMD directives - are already in full implementation, the domestic system relies primarily on strategic documents and by-law initiatives.

In particular, the lack of legally defined obligations in the area of ESG reporting and data verification is highlighted, which indicates the need to establish an integrated legal framework for sustainable financing.

This situation confirms the thesis that institutional development and regulatory infrastructure lag behind market trends that have already been clearly established within the European Union.

Specific challenges include: lack of legal definition of sustainable fund and ESG reporting; the early phase of standardization in institutions (KHOV, NBS); shallow and illiquid market; limited local expertise for evaluating "green" projects. These factors indicate that the domestic market is just entering the transition towards EU standards, but that there are initial steps for the future introduction of ESG products.

In conclusion, the main challenges of sustainable funds were above all legal and institutional: uneven application of regulations, unclear definitions, risk of greenwashing and limited supervisory capacities. At the same time, the growth of investor interest and the evolution of the European framework created pressure for strengthening responsibility and transparency. For Serbia, the priority is proactive alignment with EU rules and capacity building so that future "sustainable funds" go beyond nominal labeling and bring measurable economic, social and environmental impact.

## 6. Perspectives and recommendations for the development of the legal framework in Serbia

The development of the legal framework for sustainable investment funds in Serbia is just beginning, while global and European trends impose the need for faster alignment with sustainable financing standards. This chapter highlights key perspectives and recommendations for normative, institutional and educational strengthening of the system.

The introduction of ESG principles is necessary for a long-term approach to the European capital market. Serbia should gradually harmonize the legislation with the basic acts of the EU:

- EU Taxonomy Regulation (2020/852) - defining sustainable activities and classification criteria;
- SFDR (2019/2088) - obligations to report on ESG factors;
- UCITS/AIFMD – inclusion of ESG risks in fund management policies.

It is necessary to precisely determine the competences of the Commission for Securities, the National Bank of Serbia and the Ministry of Finance, as well as pass by-laws for consistent implementation. Alignment can be implemented through three models: changes to existing laws,

adoption of regulations on ESG reporting or adoption of a special law on sustainable finance, solutions implemented by some other transition countries.

The first practical step should be the obligation to publish ESG information in prospectuses and fund management reports. This would allow investors to see:

- the way of applying ESG principles in investment decisions,
- measurable indicators of sustainability, i
- the percentage of property aligned with taxonomic criteria.

This measure would increase transparency and trust, without additional administrative burden.

Effective implementation of the regulations requires the strengthening of the Securities Commission through the establishment of a unit for sustainable finance, staff training and development of a methodology for monitoring ESG investments. The National Bank of Serbia could additionally contribute by establishing a national ESG data base and supporting green financing. Coordinated cooperation of institutions would create an integrated supervisory system that links financial stability and sustainability. Similarly, the introduction of analytical frameworks based on digital models and explainable artificial intelligence can further strengthen regulatory processes, enabling timely and transparent risk assessment in accordance with ESG principles[35].

In order to protect the market and investors, it is necessary to introduce anti-greenwashing mechanisms:

- data verification by independent auditors,
- fines for unjustified use of the labels "green" and "sustainable",
- a public register of funds that meet ESG standards, under the supervision of KHOV.

These measures would increase the integrity and confidence in the domestic capital market.

Reforms should be accompanied by continuous education of management companies, advisors and investors. Universities and professional associations should develop ESG finance training and certification, while public campaigns promote a responsible investment culture. Sustainable financing thus grows from a regulatory requirement into a permanent standard of professional practice and corporate governance.

Perspectives for the development of the legal framework of sustainable funds in Serbia are based on harmonization with EU regulations, strengthening of institutional capacities and promotion of transparency.

The goal is the evolution of the system from a traditional to an integrated model that connects financial stability and sustainable development. In this process, regulatory bodies, academic institutions and the investment community play a crucial role, through whose action sustainable investing can become a standard of responsible business, not just a regulatory obligation.

## **7. Conclusion**

The research showed that the European Union has built a comprehensive legal framework for sustainable finance through the Taxonomy, the SFDR and the revised UCITS/AIFMD directives, but that regulatory complexity and uneven methodology for assessing ESG factors still limit its effectiveness. The lack of standardized data and differences in the interpretation of sustainability concepts make it difficult to verify ESG claims and reduce investor confidence. Empirical findings from ESMA [20] and ALFI[33] reports confirm the strong quantitative growth of sustainable funds, with the dominance of those that only promote sustainable features (Article 8 SFDR), while funds with strictly defined sustainable goals (Article 9 SFDR) are still in the minority.

The results of the research confirmed the hypothesis that the lack of standardization and transparency limits the functionality of the market of sustainable funds, making sustainable financing primarily a regulatory concept and not a fully developed market practice. In the case of the

Serbia, it has been shown that the process of normative alignment with EU standards is progressing, but without an institutional infrastructure for reliable ESG reporting and data control.

The contribution of the work is reflected in connecting the legal and empirical perspective of sustainable finance, which indicates that the legal framework must be supplemented with informational and institutional capacities. Future research should focus on the longitudinal analysis of the effects of the SFDR and the Taxonomy on fund performance and capital flows, as well as on the construction of common European standards for measuring the actual sustainability of investments.

Ultimately, the development of sustainable investment funds reflects a broader transformation of the financial system – a shift from the logic of short-term profitability to a paradigm of long-term social responsibility. Sustainable finance thus becomes more than a regulatory framework: it represents a measure of the ability of modern institutions to harmonize economic growth with ethics and public interest. Their further evolution will not only depend on laws and regulations, but also on the readiness of the market and society to accept sustainability as a permanent value and not a passing trend.

**Conflicts of Interest:** The authors declare no conflict of interest.

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