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SFDR 2.0 and the Transatlantic ESG Challenge

As ESG regulation in the EU and US continues to diverge, fund managers must navigate inherent tensions between the regimes and competing investor demands in order to maintain access to transatlantic capital.

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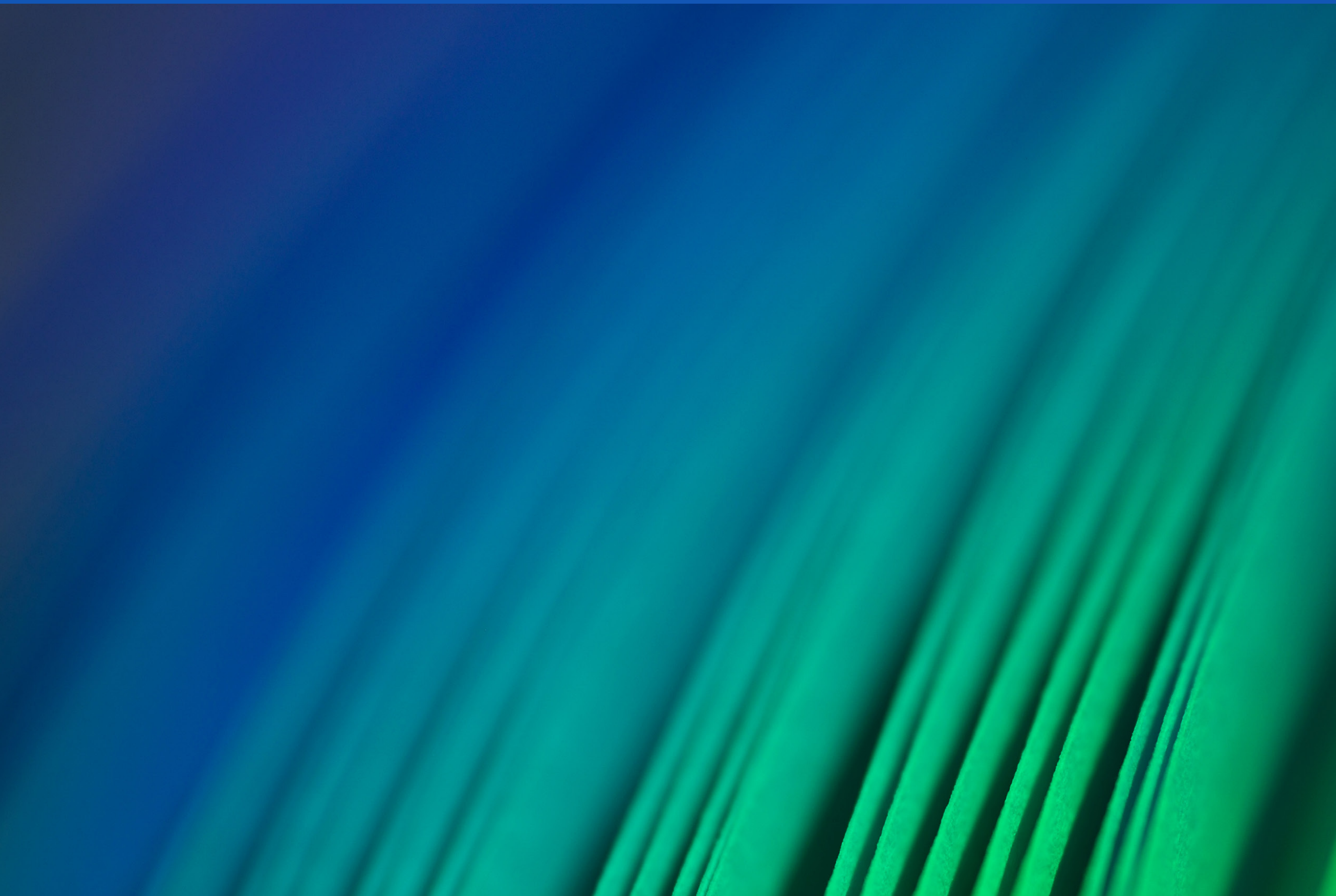

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Key Points

- SFDR 2.0 marks another step in the EU-US divergence on sustainable finance and asset management ESG regulations.
- Heightened geopolitical tensions and strategic policy shifts in Europe have widened the scope of ESG, presenting defence-related investment opportunities for sustainability-focused capital.
- Greenwashing remains a concern for the EU, and SFDR 2.0 as proposed would set a significantly higher threshold to qualify as sustainable.
- The mandatory exclusions proposed under SFDR 2.0 would heighten the incompatibility risk between EU and US investors.

Main Focus Areas

1. The New SFDR 2.0 Categorisation Regime: What Changes?

At its inception, the Sustainable Finance Disclosure Regulation (SFDR) was intended to be a disclosure framework which would increase the quality and quantity of information available to investors, driving up standards and helping them make more informed allocation decisions. Under the current framework, Article 6 applies to all financial products in scope of SFDR and requires disclosure of how sustainability risks are integrated into the investment decision-making process as well as an assessment of their likely impact on returns. Article 8 establishes that products “promoting” environmental or social characteristics must show how they promote such characteristics, while Article 9 requires products with a “sustainable investment objective” to explain that objective and demonstrate how it is attained.

Once SFDR came into effect, the Articles setting out the disclosure requirements quickly came to be used by the market as labels denoting a particular level of sustainability. We saw pressure from investors who wanted Article 8 disclosures as a minimum, and at the same time we saw sponsors pushing to get “‘up the rankings” as a way to differentiate themselves from competitors and gain an edge. Together, products disclosing under Articles 8 and 9 account for almost 50% of EU assets under management, representing more than 60% of EU investment funds.[1] While the EU wants to encourage the allocation of capital to sustainable investments, the definition of “sustainable” has noticeably shifted since SFDR was originally implemented. There are competing policy aims at EU level, with a far greater emphasis on defence, technology, and industrial capacity since the Russian invasion of Ukraine, which now features alongside a continued push to crack down on greenwashing and a sweeping simplification agenda. These three priorities can be seen in the changes between SFDR and the proposed wording for SFDR 2.0, as well as in related actions and legislation, including notably in the higher standards imposed by the ESG Basics category versus the existing Article 8, paired with a clearer and more narrowly defined restriction on prohibited weapons. These defence-oriented changes to sustainable finance are already having an effect. For example, since the Commission published a clarification of the role that the defence sector can play in sustainable finance, there has been a sharp uptick in actively managed ESG funds’ exposure to the aerospace and defence industry.[2]

From an industry perspective, SFDR’s implementation has been marked by considerable complexity and costs. There are also practical challenges, as fund managers have faced difficulties accessing reliable and comprehensive ESG data from portfolio companies (an issue which is unlikely to be solved soon given the reduction in scope of the Corporate Sustainability Reporting Directive).

The EU accepts that these are issues with the current framework, but seems to particularly focus on the issue of greenwashing, from what it perceives as a misuse of Article 8 and Article 9 as labels.

The SFDR 2.0 proposal, as currently drafted, replaces this disclosure-based system with a formal product categorisation regime. Products would fall into one of three categories:

- “Sustainable” — for products investing in already-sustainable assets or pursuing sustainability objectives);

- "Transition" — for products investing in companies or activities on a credible path to sustainability); and
- "ESG Basics" — for products integrating sustainability factors beyond risk considerations.

Under the current SFDR 2.0 proposal, at least 70% of a product's investments must meet the relevant criteria in order to qualify for any category. This marks a significant increase from the 50% threshold under the current European Securities and Markets Authority fund-naming guidelines. Each category also carries mandatory exclusions: all three categories must exclude investments in controversial weapons, tobacco, violations of the UN Global Compact, and companies involved in hard coal and lignite. The Transition and Sustainable categories impose additional fossil fuel restrictions, with the Sustainable category carrying the most stringent exclusions, including companies with any involvement in oil or gas exploration and development.

2. Mandatory Exclusions: The Core Transatlantic Tension

Under the current SFDR, the concept of "do no significant harm" (DNSH) operates as a principle-based requirement: financial market participants must consider how their sustainable investments avoid significantly harming environmental or social objectives, but the application of this principle has been left to interpretation by individual firms. The draft SFDR 2.0 proposal takes a fundamentally different approach, replacing this flexible principle with a closed list of mandatory exclusions that apply as binary, non-negotiable restrictions on what categorised products can invest in. This shift represents a significant reduction in the discretion available to fund managers, and is likely a result of the EU's desire to take a tougher approach to greenwashing. For funds seeking to qualify under any sustainability category, the exclusions are not optional.

These mandatory exclusions present a particular challenge for fund managers seeking to raise capital from both EU and US investors. Even the ESG Basics category — the least restrictive of the three — requires funds to exclude investments in companies involved in:

- "controversial" weapons (anti-personnel mines, cluster munitions, chemical weapons, and biological weapons);
- the cultivation and production of tobacco;
- violations of the UN Global Compact principles or OECD MNE Guidelines; and
- hard coal and lignite (if more than 1% of revenue is derived from these).

Various US state laws actively protect investments in sectors such as fossil fuels and firearms, and in some states fund managers face legal or political risk if they exclude these sectors from their investment universe. This creates an inherent tension where compliance with EU sustainability categorisation requirements may conflict directly with US investor expectations or state-level anti-ESG legislation.

Notably, the restriction on controversial weapons is narrower and better defined than it used to be. As part of the EU's Defence Readiness Omnibus, Delegated Regulation (EU) 2025/1775 replaces the definition of controversial weapons with the new term "prohibited weapons". This in turn is defined to mean “anti-personnel mines, cluster munitions, biological and chemical weapons … which [are] expressly prohibited by the international arms conventions to which the majority of Member States are parties”. The previous definition captured “controversial weapons as referred to in international treaties and convention, United Nations principles and … national legislation”. It is now far more practicable to say with a reasonable degree of certainty whether a particular company is involved in activities related to prohibited weapons, in a way that was not possible under the old definition. This means that this mandatory exclusion under SFDR 2.0 is far more compatible with US laws than originally anticipated, and in conjunction with other proposals under the Defence Readiness Omnibus, could pave the way for a new breed of defence-focused ESG funds in Europe (see Section 6 for more details).

However, despite the potential opportunities in the defence sector, the overall effect of the mandatory exclusions still creates a pressing concern for asset managers with existing Article 8 funds that have US investors. They will be faced with the challenge of trying to recategorise based on an existing portfolio of assets that was built in accordance with a strategy that may no longer fit with the new categories, while trying to remain compliant with US laws and rules that may require them to exclude ESG factors from their decision-making process.

Forced recategorisations may be an intended side effect of the changes proposed under SFDR 2.0; the Commission certainly does not hide the fact that it is seeking to crack down on what it perceives as greenwashing resulting from the (mis)use of Articles 8 and 9 as labels in conjunction with comparatively low standards to qualify for a particular categorisation.

3. Recategorisation Risk: What Happens to Existing Article 8 Funds?

Article 8 funds currently represent a steadily increasing proportion of EU investment funds,[3] making the question of how these products will transition to the new regime one of the most commercially significant aspects of SFDR 2. While closed-ended funds benefit from an exemption that permits continued reliance on the existing disclosure framework, the decision whether to recategorise is not straightforward. Fund managers face competing pressures: EU investors may expect or require recategorisation to a sustainability category, while US investors, particularly those subject to state anti-ESG laws, may resist the mandatory exclusions that recategorisation entails. In any event, many current Article 8 funds will face the practical issue that recategorisation under the new regime will not be simple and could well be incompatible with their existing portfolio and strategy given the more stringent criteria to be classified as an ESG Basics fund. Early analysis by Commerzbank found that around a third of Article 8 funds by assets under management could fail to qualify for any of the labels under the proposed new regime.[4]

Article 17 as amended by the draft SFDR 2.0 proposal provides an exemption for closed-ended products which were “created and distributed” before SFDR 2.0 applies. While a specific date has not yet been determined, this will be 18 months after SFDR 2.0 enters into force, meaning a likely application date of mid-2028. Therefore, private closed-ended funds that have held a final closing by this date that are not able to recategorise (e.g., due to being in breach of the mandatory exclusions or not hitting the 70% threshold) will have the option of continuing in line with the status quo. In contrast, open-ended or evergreen vehicles will not benefit from this exemption so will be forced to confront the issue by the application date. Certain industry groups have pushed for fund managers to be able to opt in earlier than the application date,[5] which could be a competitive advantage in the 18-month window between SFDR 2.0 entering into force and the application date, but this is not provided for in the current draft of

SFDR 2.0. It is currently expected that the number of funds in the ESG Basics category may be fewer than half of the current Article 8 funds,[6] due to the more stringent requirements imposed.

However, there may be significant pressure from limited partners (LPs) for funds to recategorise, particularly where the investor is seeking to rely on Article 9(a)[7] (e.g., where it is following a fund of funds strategy and is therefore reliant on its underlying investments being categorised under the SFDR 2.0 regime) or is otherwise operating under an ESG investment mandate.[8] SFDR disclosure obligations are often effectively policed by LPs, and there are signs that investors are holding sponsors' ESG reports to higher standards[9] and that the quality of such reports is being factored into the decision-making process for capital allocations.[10] An ability to recategorise an existing Article 8 fund to an ESG Basics fund may therefore come to be a distinguishing factor in the market in the eyes of certain investors in an environment where there has been a bifurcation in disclosure regimes between funds that have recategorised and those which have not. SFDR has already shaped capital flows, with investors willing to commit more capital to Article 8 and 9 funds and declining interest in Article 6 funds,[11] meaning products which are able to recategorise (and new funds raised as ESG Basics funds) are likely to be particularly sought after. The number of ESG Basics funds will be lower than the current number of Article 8 funds available (see above), but the number of investors with ESG mandates and existing reporting obligations shows no sign of dropping. Successful recategorisation by closed-ended funds could boost future fundraising efforts, with LPs looking at track records for responsible investing.[12] Meanwhile, recategorisation for open-ended private funds may prove even more important, as they are at risk of a redemption squeeze on the application date for SFDR 2.0 (subject to any phase-in period) from investors reallocating into investments still categorised as sustainable.

On the other hand, recategorisation does carry some risk. Firstly, there is a higher risk of inadvertent breaches, particularly if the fund is very close to the minimum 70% threshold; some managers may prefer to retain the greater flexibility afforded by the current regime. Secondly, and of particular importance for managers with a significant proportion of US investors, institutional US investors in states with strong anti-boycott laws will have little appetite for the recategorisation, particularly if the mandatory exclusions are interpreted as putting those investors at risk of, or in breach of, such laws. In particular, institutional investors subject to current or potential future US state anti-ESG laws may view mandatory exclusions as problematic or conflicting with state-level requirements. See Section 5 below for further details on this topic.

The challenge of recategorisation is compounded where fund managers have made bespoke commitments to individual investors through side letters. Under the current SFDR framework, side letters have provided a valuable mechanism for reconciling competing investor expectations, but SFDR 2.0's mandatory exclusions and fund-level categorisation requirements may significantly curtail this flexibility.

4. Side Letters and LP Commitments: Managing Competing Obligations

The transition from SFDR to SFDR 2.0 marks a fundamental shift in how fund managers may deploy side letters to reconcile competing investor obligations. Although side letters will remain valuable instruments for addressing investor-specific requirements, their effectiveness in bridging the divide between EU sustainability categorisation demands and US anti-ESG constraints is diminished under the new framework.

The current SFDR framework's principle-based approach to Article 8 and Article 9 disclosures has afforded fund managers considerable latitude in characterising and implementing their sustainability strategies. This flexibility has extended to side letter arrangements, enabling managers to negotiate sustainability commitments with particular investors, including additional exclusions, supplementary reporting obligations, or specific sustainability targets, while preserving a fund-level investment approach acceptable to investors without such requirements.

SFDR 2.0 fundamentally alters this dynamic. The mandatory exclusions under the new framework impose rigid constraints that cannot be modified or carved out through side letter negotiations. These binary exclusions, as currently proposed, may prove incompatible with US state-level laws and regulations, potentially deterring US investment in categorised funds.

5. The US Regulatory Landscape: Debanking, Anti-Boycott, and Political Risk

Over the past several years, numerous US states, including Texas and Florida, have enacted legislation designed to counter what they perceive as politically motivated ESG investment practices. Thus, beyond investor preference, this patchwork of state-level regulations often directly conflicts with the EU's sustainability categorisation framework. Fund managers must therefore navigate both legal and political risk amid widening regulatory divergence, with some considering whether to carve out US investors from certain funds — a decision that may result in reduced US assets under management.

The mandatory fund-level exclusions introduce a further layer of complexity. A manager implementing SFDR 2.0's required exclusions may face claims that its investment policies constitute a form of "debanking", effectively denying capital to companies in excluded sectors, such as fossil fuels or firearms, based on their industry classification rather than their financial merit or creditworthiness.

Notably, a leaked draft of SFDR 2.0 circulated in early November 2025 suggested that alternative investment funds (AIFs) marketed exclusively to professional investors would be exempt from mandatory categorisation, effectively permitting such AIFs to opt out of SFDR 2.0 and its associated exclusions on a voluntary basis. However, the formal proposed draft released on 20 November 2025 eliminated this exception, extending the mandatory categorisation regime to all in-scope funds regardless of their investor base. The removal of this exemption means that, as proposed, existing Article 8 or 9 funds will need to transition to one of the new categories under SFDR 2.0, unless the fund is closed-ended and created and distributed before the new rules apply (see Section 3 above for more on this point).

This development underscores the need for fund managers to proactively engage with the legislative process and to prepare for a regulatory environment in which the transatlantic divide may only widen. As SFDR 2.0 progresses towards finalisation, managers operating across both jurisdictions must carefully assess their structuring options and investor relationships to navigate the competing demands of EU sustainability requirements and US constraints.

6. The Defence Sector: A Potential Bridge?

Since the start of 2025, there has been a marked shift in the EU's policy on defence (with parallel developments occurring in the UK). The White Paper for European Defence – Readiness 2030 (the White Paper) recognises that the European defence industry has experienced underinvestment for decades and, in the face of growing threats and a shifting international order, that it needs to rapidly develop a stronger and more resilient defence industrial base.

The White Paper sets out the ambitious target of developing a functioning EU-wide market for defence equipment (which would be one of the largest domestic defence markets globally). It calls for regulatory simplification and harmonisation, and acknowledges that "the defence sector remains an underserved market due to limitations in investment policies of public and private financial institutions", implicitly recognising that the bloc's sustainable finance rules may have reduced capital flows to the defence industry. There is an explicit call for increased spending on defence from both public and private sources:

> *"Boosting public investment in defence is indispensable, but it will not be sufficient. European companies including Small and Medium Enterprises and Mid-Caps must have better access to capital, including guarantee instruments for de-risking investments, to bring their solutions to industrial scale and to drive the industrial ramp-up that Europe needs".*[13]

The White Paper also notes that "both the finance and defence sector may benefit from additional clarification on the application of the SFDR". The Commission Notice on the application of the sustainable finance framework and the Corporate Sustainability Due Diligence Directive to the defence sector (C/2025/4950)[14] (the Commission Notice) is a direct outcome of this policy shift.

The Commission Notice makes a number of important clarifications. It emphasises that the EU's sustainable finance framework is "neutral" with regards to the defence industry. This means that the defence sector generally should not be perceived as any more or less sustainable than any other (subject to appropriate diligence on involvement with prohibited/controversial weapons). However, and perhaps more importantly, it confirms that "the Commission recognises the defence industry as a crucial contributor to the resilience and security of the Union, and therefore to peace and social sustainability". The implication is that, at least in respect of EU defence companies, these companies are more likely to be inherently sustainable. A defence-focused investment fund could feasibly adopt an SFDR strategy focused on the social characteristics of contributing to peace and social sustainability. This is further facilitated by remarks in the Commission Notice recognising that the defence sector is heavily regulated, meaning compliance with applicable laws, treaties, and risk mitigation processes are strong indicators that a portfolio company would meet the threshold for sustainable characteristics. Finally, the Commission Notice also provides investors and operators with comfort that they can rely on the due diligence requirements and measures put in place at portfolio company level for the purposes of fulfilling the UN Global Compact Principles and the OECD Guidelines, and for mitigating against principal adverse impacts (PAIs).

However, at the same time it should be noted that there is as yet no uniform definition of "defence", so investor definitions and preferences may vary. Strong governance remains central to risk management here, potentially enabling investors to get comfortable that a particular defence company is able to be deemed a sustainable investment. It is therefore vital to have robust due diligence at the investment stage and clear disclosures when marketing and fundraising.

Furthermore, the extent to which defence companies based outside of the EU can be classed as sustainable is still unclear. The EU's policy intention is fundamentally to increase investment in its own defence capabilities. It seems reasonable that investments in Norway would be covered by the same analysis, given it is a full partner in EU defence programmes. It is also possible that UK defence companies would also be able to benefit from this analysis, given that the UK is described as "an essential European ally" and its defence interests are closely aligned with the EU. However, additional steps would likely be necessary to show that such a company was contributing to the peace and security of the EU, for example by supplying EU Member States.

In terms of forming a strategy that would allow both EU and US investors to come into the same defence-focused fund qualifying under the new ESG Basics category, a sensible starting point could be to:

1. set the target integrated sustainability factors as the promotion of peace and social sustainability of the EU;

2. establish a geographic focus of specific EU jurisdictions (and, potentially, closely aligned EU allies), which should align with those that have ratified all applicable international treaties from a prohibited weapons perspective; and

3. rely on "compliance with applicable laws" (along with other standard diligence procedures) as an indicator of the sustainability factors.

The above theoretically threads the needle of EU investor demand for sustainability with the more anti-ESG requirements of certain US investors.

It is perhaps worth noting that the Nordic states, which were in many ways the main driver behind the original push for Article 8 as a minimum standard in Europe, are also very exposed to Russia. Their ability to wield outsized influence as limited partners mean that they are likely to set the tone on market practice once the proposed SFDR 2.0 rules come into force, and it will be interesting to see whether there is a directional shift in their approach in light of the renewed emphasis on defence capabilities.

7. Timeline and Transition: Planning for Implementation

At present, the SFDR 2.0 proposal is still working its way through the EU's legislative process.

- **Adoption**: SFDR 2.0 is currently expected to be adopted in 2027.

- **Effective date**: Following adoption there will be an 18-month implementation period, suggesting a likely application date of mid-2028.

Sponsors who are currently fundraising for an Article 8 fund should seek to future-proof their SFDR strategies if they intend to recategorise, and if not, may need to accelerate the process in order to close ahead of the effective date for SFDR 2.0.

8. Developing a Transatlantic Strategy: Latham's Integrated Approach

Latham's global platform provides deep, integrated transatlantic expertise in ESG regulations impacting on asset managers. The SFDR 2.0 proposal represents another step in the divergence between the EU and the US, making ongoing compliance with both markets increasingly challenging. Latham is uniquely positioned to help navigate the competing demands of European and US investors, and to help sponsors maintain access to diverse sources of capital. This comes at a crucial moment as the EU looks to mobilise private capital as a major driver in ramping up its defence, technological, and industrial capabilities.

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Endnotes

[1] COM/2025/841 final, Explanatory Memorandum, page 2.

[2] https://global.morningstar.com/en-gb/sustainable-investing/how-esg-funds-learned-love-weapons (accessed 20 February 2026).

[3] Langham Hall, "Beyond the rhetoric: Where is investor appetite for ESG in Europe really landing?" (4 March 2026).

[4] *Responsible Investor*, Investors warn of tricky transition ahead for Article 8 funds under new SFDR (25 November 2025).

[5] See, for example, the ICMA commentary and recommendations for SFDR review (4 February 2026, as updated on 9 February 2026).

[6] Sustainalytics: SFDR 2.0 in Figures: Impact Analysis (27 November 2025).

[7] Article 9(a) of the draft SFDR 2.0 proposal allows a product to be categorised as ESG Basics, Sustainable, or Transition based on at least 70% of its underlying investments meeting the applicable categorisation.

[8] This includes ca. three-quarters of European institutional investors (Hoover Institution: 2024 Institutional Investor Survey on Sustainability).

[9] Private Equity International: LP Perspectives 2025 Study.

[10] Malk Partners: Top Reasons Private Market Investors Need Annual ESG Reports (7 February 2025).

[11] Langham Hall, "Beyond the rhetoric: Where is investor appetite for ESG in Europe really landing?" (4 March 2026).

[12] Malk Partners: Top Reasons Private Market Investors Need Annual ESG Reports (7 February 2025).

[13] White Paper for European Defence – Readiness 2030.

[14] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C_202504950.

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