

Mandatory Exclusion Screens Under SFDR 2

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The European Commission (the “Commission”) released in November 2025 its proposed amendments to the Sustainable Finance Disclosure Regulation (“SFDR 2”). SFDR 2 aims to create a labelling regime for funds that make different types of environmental or social claims, requiring funds to meet new criteria under three new sustainability categories, currently proposed as Article 7 “Transition”, Article 8 “ESG Basics” and Article 9 “Sustainable”. To qualify for those categories, funds need to comply with new minimum requirements, including sets of excluded investment categories—see the Appendix. These broadly cover asset classes which are excluded from benchmark indices under the European Union’s (“EU’s”) Paris-aligned Benchmarks.¹ ESMA has applied a version of these exclusions to funds using ESG or sustainability-related terms in their names in its “ESMA Fund Names Guidelines”, although it is expected that these rules will be phased out when SFDR 2 applies. As a result of the mandatory exclusions, some private funds have removed environmental or social terms in their names. This Debevoise In Depth assesses the new exclusion screens under SFDR 2 and the implications for asset managers.

Origin of Exclusions

As above, the proposed exclusions in SFDR 2 derive from the EU’s standards for Paris-aligned Benchmarks, which are indices used to measure the climate-related performance of sets of companies. Under these standards, companies that derive more than a set percentage of their revenues from activities related to coal, oil, gas or electricity generation with a high greenhouse gas (“GHG”) intensity are excluded from the EU Paris-aligned Benchmarks, as well as companies involved in activities related to prohibited weapons or tobacco or companies that are found to have violated United Nations Global Compact (“UNGC”) principles or the Organisation for Economic Cooperation and Development (“OECD”) Guidelines for Multinational Enterprises.²

¹ Article 12(1) of Commission Delegated Regulation (EU) 2020/1818 (“Benchmark Regulation DR”).

² As part of its Defence Readiness Omnibus, the Commission enacted a Delegated Regulation, which entered into force in January 2026, amending the Benchmark Regulation DR to change “controversial weapons” to

Indices under the Benchmarks Regulation DR comprise listed issuers, where benchmark administrators can obtain sufficient publicly available information to apply the exclusions.

Certain of the exclusions are linked to principal adverse impact indicators in the SFDR, namely companies involved in controversial weapons and companies and violations of UNGC Principles and OECD Guidelines for Multinational Enterprises.

Concerns Raised by Industry

Applying the set of mandatory exclusions to investments in equity or debt of privately owned companies has raised a number of significant issues. Under the Commission's draft proposal for SFDR 2, exclusions do not apply to sovereign investments, such as government bonds. As SFDR 2 currently stands, the exclusions are "binary": sponsors must ensure that the exclusions are not breached at the point of investment and must take steps to divest if an investee company subsequently falls within the exclusions list. As private equity and debt investments are typically illiquid, sale of an investment on the grounds that it falls within the exclusions list raises significant issues and will often not be in investors' best interests, in particular where noncompliance arises from circumstances beyond the sponsor's control, such as changes in the strategy of a portfolio company in which a fund holds a minority stake. The private equity industry lobby has suggested various qualifications directed at a regime where breaches of exclusion criteria which arise during the holding period and outside of the manager's control do not automatically disqualify a product from its SFDR category unless the manager has failed to take all reasonable steps within its powers to remedy the breach. Under this regime, managers would use "best efforts" to comply with the exclusions, disclosing how they assess compliance and address breaches based on available information, materiality and their actual powers of influence and describing circumstances where divestment may not be feasible.

As an additional concern, framing the exclusion criteria by reference to a proportion of a company's revenue³ raises the question as to whether the revenue needs to be generated by a company's direct involvement in the restricted sector or whether a company that

"prohibited weapons", meaning specifically "anti-personnel mines, cluster munitions, biological and chemical weapons the use, possession, development, transfer, manufacture, and stockpiling of which is expressly prohibited by the international arms conventions to which the majority of Member States are parties", as listed in the Annex to the Delegated Act. This is intended to address uncertainty over what comprised "controversial weapons" in the prior draft, which in the Commission's view has discouraged investors from the defence sector more generally.

³ For example, the restriction on sustainable funds from investing in companies that derive 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels.

indirectly generates revenue from a sector—such as financing oil fuel projects, facilitating trading in oil fuels (for instance, through a software application) or otherwise providing a support service, such as engineering or equipment leasing, to the sector—is also in scope. Unless the Commission gives guidance on this point, it is a matter of judgement for the asset manager, with the conservative view being that a close link between the company’s business and the restricted sector—often the case where the company supplies a specialist product or service to the restricted sector—is sufficient for the exclusion to apply.

In the industry lobby following publication of the SFDR 2 proposals, there has been considerable concern about the exclusion for companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal or lignite, which will apply to all funds within the new categories. For instance, investment in the energy transition may well include investment in companies, such as energy distribution infrastructure, where a small proportion of revenue is linked to coal, typically with a view to reducing that proportion over time. It is worth noting that, as proposed under SFDR 2, applying the coal and lignite exclusion to Article 7 (Transition) and Article 8 (ESG Basics) funds goes beyond the ESMA Fund Names Guidelines, which apply this exclusion to funds using environmental-, impact- or sustainability-related terms but not funds using transition-related terms.

Fund of funds investors obtaining exposure to underlying investee companies through primary or secondary transactions have long been wary of mandatory exclusions given the lack of control they can exercise over selection of underlying investee companies and lack of contractual privity with those companies. To some degree, fund of fund investors can incorporate restrictions, such as by including equivalent restrictions in side letters when they make a primary investment, although that requires negotiation on a case-by-case basis. It is not generally possible to obtain equivalent protections in a secondary investment. As a result, the industry lobby has encouraged the Commission to allow funds of funds to observe the applicable exclusions by various means, depending on their access to information about, and control of the portfolio of, the underlying funds and whether they are bound to integrate the exclusions into the documentation of the underlying fund or the investment documentation.

Conclusion

The Commission’s introduction of mandatory exclusion criteria is a development of its approach in the EU Benchmarks Regulation DR and ESMA Fund Names Guidelines. Mandatory and inflexible exclusions pose considerable problems for private fund sponsors, which may well pursue more specialist strategies, such as investment in

energy transition infrastructure, where an exclusion can materially constrain the strategy. In addition, private funds may have smaller portfolios than funds that invest in liquid securities, have less—or less timely access to—relevant data and, in some strategies, such as debt or minority equity, have limited control of or opportunities for engagement with the investee company to prevent management taking decisions which may trigger a breach.

Appendix: Proposed Exclusion Categories

<p>Article 7 (Transition)</p>	<p>Exclusions for EU Paris-aligned Benchmarks:</p> <ul style="list-style-type: none"> • companies involved in any activities related to prohibited weapons; • companies involved in the cultivation and production of tobacco; • companies that benchmark administrators find in violation of UNGC principles or the OECD Guidelines for Multinational Enterprises; and • companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; <p>in each case with the exception of investments in EU Green Bonds or other use of proceeds instruments that do not fund underlying activities related to bullet points 1, 2 and 4 above, provided the issuer is not excluded under bullet point 3 above.</p> <p>Additional excluded investments in companies that:</p> <ul style="list-style-type: none"> • develop new projects for the exploration, extraction, distribution or refining of hard coal and lignite, oil fuels or gaseous fuels; or
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	<ul style="list-style-type: none"> • develop new projects for, or do not have a plan to phase out from, the exploration, mining, extraction, distribution, refining or exploitation of hard coal or lignite for power generation.
<p>Article 8 (ESG Basics)</p>	<p>Exclusions for EU Paris-aligned Benchmarks:</p> <ul style="list-style-type: none"> • companies involved in any activities related to prohibited weapons; • companies involved in the cultivation and production of tobacco; • companies that benchmark administrators find in violation of UNGC principles or the OECD Guidelines for Multinational Enterprises; and • companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; <p>in each case with the exception of investments in EU Green Bonds or other use of proceeds instruments that do not fund underlying activities related to bullet points 1, 2 and 4 above, provided the issuer is not excluded under bullet point 3 above.</p>
<p>Article 9 (Sustainable)</p>	<p>Exclusions for EU Paris-aligned Benchmarks:</p> <ul style="list-style-type: none"> • companies involved in any activities related to prohibited weapons; • companies involved in the cultivation and production of tobacco; • companies that benchmark administrators find in violation of UNGC principles or the OECD Guidelines for Multinational Enterprises;

	<ul style="list-style-type: none"> • companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; • companies that derive 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels; • companies that derive 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels: and • companies that derive 50% or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO₂ e/kWh. <p>in each case with the exception of investments in EU Green Bonds or other use of proceeds instruments that do not fund underlying activities related to bullet points 1, 2 and 4 to 7 above, provided the issuer is not excluded under bullet point 3 above.</p> <p>Additional excluded investments in companies that:</p> <ul style="list-style-type: none"> • develop new projects for the exploration, extraction, distribution or refining of hard coal and lignite, oil fuels or gaseous fuels; or • develop new projects for, or do not have a plan to phase out from, the exploration, mining, extraction, distribution, refining or exploitation of hard coal or lignite for power generation. <p>in each case with the exception of investments in EU Green Bonds or other use of proceeds instruments that do not fund underlying activities related to bullet points 1, 2 and 4 to 7 above, provided the issuer is not excluded under bullet point 3 above.</p>
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Please do not hesitate to contact us with any questions.



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