



ERM
SUSTAINABILITY
INSTITUTE

EU REGULATIONS POLICY ALERT

On your marks

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Contents	Introduction	3
	Regulation 1 – CSRD/ESRS: Execution starts now	4
	Building a solid digital foundation	7
	Regulation 2 – CSDDD: Only big players and big risks	8
	Using verified disclosures in communication	10
	Regulation 3 – EUDR: Switching to pragmatism	11
	Boosting credibility through robust assurance	13
	Regulation 4 – CBAM: Pushing the borders	14
	Regulation 5 – SFDR 2.0: Substantial overhaul	16
	Conclusion	18



Introduction

In early 2025, the European Union paused its rapid expansion of sustainability regulations and began a push for simplification, introducing the EU Omnibus proposal for sustainability reporting and due diligence. Many iterations and EU negotiation rounds later, outcomes are taking their final shape, giving companies long-awaited clarity on their sustainability reporting and due diligence obligations.

Changes to the Corporate Sustainability Reporting Directive (CSRD), the Corporate Sustainability Due Diligence Directive (CSDDD), and the Carbon Border Adjustment Mechanism (CBAM) — which vastly reduce the number of requirements and in-scope companies — have now cleared all political hurdles. The simplified version of the European Sustainability Standard (ESRS) will likely be approved in mid-2026.

Regulations that are not part of the initial Omnibus package — such as the EU Deforestation Regulation (EUDR) and the Sustainable Finance Disclosure Regulation (SFDR) — have also been assessed for simplification. This has led to substantially less complex due diligence rules for companies covered by the EUDR and a far-reaching SFDR 2.0 proposal to overhaul the existing SFDR rules.

This policy alert will bring companies up to speed on the changes, outstanding issues, and timelines for all the regulations and standards mentioned. But perhaps more importantly, we focus on practical steps that companies should take next, not only to prepare for the regulations themselves, but also to prepare their digital systems, assurance, and communication approach.

We are entering a new phase in EU corporate sustainability reporting and due diligence, in which companies will increasingly feel the weight of the EU's regulatory ecosystem. At the same time, the new simplified regulations offer more opportunities than before to leverage the reporting and due diligence process for commercial gain, thanks to reduced data points and a stronger focus on core material issues. How much of that gain companies successfully capture will depend on the speed and thoroughness of their preparations.

CSRD/ESRS: Execution starts now

The Corporate Sustainability Reporting Directive (CSRD) and the European Sustainability Reporting Standards (ESRS) work in tandem: the CSRD provides the legal framework, while the ESRS details the disclosures and provides guidance on the steps companies must follow to fulfill their CSRD reporting obligations. The revised simplified CSRD has been fully approved and **published in the EU’s Official Journal**. Member states have until March 2027 to transpose the changes into national law. We expect ESRS revisions to be fully approved by mid-2026. Together, the simplified versions of CSRD and ESRS can form a springboard for easier compliance and increased business opportunities.



Key features of the amended version of the CSRD/ESRS:

Reduced scope	Simplified reporting (ESRS)	Value chain light	Delayed timeline
<ul style="list-style-type: none"> Listed (Wave 1) and unlisted (Wave 2) EU companies with >1000 employees and >€450 million turnover (wave 3, which consisted of listed SMEs, no longer applies). Non-EU companies with >€450 million turnover across the EU and a subsidiary or branch with >€200 million turnover (wave 4). # Of in scope companies reduced by 85%. Similar reduction in # of companies required to apply the EU Taxonomy (which classifies which corporate activities count as sustainable). 	<ul style="list-style-type: none"> 61% reduction in mandatory data points; all voluntary disclosures removed. Simplified Double Materiality Assessment (DMA) with a top-down approach to assess materiality. Sector-specific standards eliminated Consolidated standards; more flexibility to present policies, actions, targets, and company narrative. Enhanced alignment with International Financial Reporting Standards (IFRS) S1/S2 (e.g., on materiality, financial quantification, and transition planning). 	<ul style="list-style-type: none"> Preference for direct data collection (over estimates or proxy data) in value chain mapping removed. Companies in scope of CSRD are prohibited from demanding info from suppliers with < 1000 employees that exceeds the Voluntary SME (VSME) standards. They can ask for it, but suppliers with < 1,000 employees have the right to refuse those requests. 	<ul style="list-style-type: none"> Wave 1 (large, listed EU companies): started in financial year beginning on/after January 1st, 2024. Wave 2 (Large, unlisted EU companies): delayed to financial year beginning on/after January 1st, 2027. Wave 4 (Large, non-EU companies): delayed to financial year beginning on/after January 1st, 2028. Wave 1 must use ESRS 2023 (eased by 2025 “quick fix” amendments) for financial year beginning on/after January 1st, 2025. For the financial year beginning on/after January 1st, 2026, they can use ESRS 2023 or the simplified ESRS, if approved. The simplified ESRS is mandatory in subsequent years. Only limited assurance of results is required.

Leverage the simplified DMA process to kickstart value creation

Companies should seize on the new top-down option to double materiality assessments (DMA), and the simplified ESRS data points to design a DMA approach that fits their specific circumstances and focuses on issues truly material to them. A tailored DMA design prevents generic assessments that produce an excess of ‘material’ items and opens the door to strategic alignment, prioritization, and value creation. Financial quantification of identified impacts, risks, and opportunities is integral to this. A top-down DMA approach is an equally valuable commercial tool for smaller companies that report voluntarily.

Consider the CSRD and ISSB as sister frameworks to be managed in tandem

Most companies covered by the CSRD will also face mandatory requirements outside the EU, based on local adoptions of the ISSB standards IFRS S1/S2. Currently, more than 30 countries are in the process of anchoring ISSB into their local disclosure frameworks. To avoid duplication and ease cross-jurisdictional reporting, companies should prepare for the CSRD and the ISSB in close concert. The new ESRS’s heightened focus on improving interoperability with the ISSB — especially regarding disclosures on financial materiality and impacts — will smooth this process, although companies will still need to respond to ISSB on a country-by-country basis — such as for country-specific climate risks.

Assess company-specific needs to avoid wasted effort or under-preparation

This is the moment for companies to reassess and invest ample time and effort in mapping their and their stakeholders’ specific needs to dial in a tailored reporting infrastructure. What regions do you operate in, and what are their reporting requirements? What are the material issues in your sector and value chain? Who are your most vocal or crucial stakeholders? The clearer that picture, the smaller the risk that your company either wastes time overpreparing or falls short, leaving it dangerously exposed.

WAVE 1 ?

Prepare for the new ESRS as soon as possible

For the 2026 financial year, EFRAG encourages Wave 1 companies still in scope to use the simplified ESRS framework. We think companies should prepare for the ESRS changes and assess whether it would be feasible to apply the simplified ESRS for the financial year starting on/after January 1st, 2026. Quickly getting on track with the new ESRS makes business sense. However, some legal uncertainty remains, as the revised ESRS hasn’t been fully approved. The transposition of CSRD changes into national law may also lead to slight jurisdictional differences in how the guideline is applied. The ESRS itself is a uniform standard across the EU.

WAVE 2 OR 4 ?

Don’t waste the extra time

Non-listed EU companies (Wave 2) and non-EU companies (Wave 4) still in scope should seize the opportunity to hit the ground running. Their later start dates — 2028 and 2029, respectively — will raise regulatory and stakeholder expectations for reporting quality once they do. Preparing early also helps companies to timely explore value-creating opportunities of the simplified DMA process and design and build the data infrastructure to support reporting and business needs.



OUT OF SCOPE ?

In almost all cases, some form of reporting remains urgent

Although CSRD reporting is no longer mandatory for many companies, three groups of companies should seriously consider continuing to report in some form or prepare to do so.

- **Large companies just under the new CSRD threshold**

Companies in this group have significant market visibility. Future revisions or company growth could also bring them back in scope. We recommend that companies in this group voluntarily apply the simplified ESRS framework.

- **Companies also operating in ISSB-focused markets**

Several countries rolling out ISSB-based disclosure frameworks — such as the UK and Australia — set mandatory compliance thresholds lower than those under the CSRD. Many EU and non-EU companies may no longer have to report under the CSRD due to higher thresholds, but could still be subject to the ISSB in other markets where they operate. Companies in this situation need to plan their reporting strategy accordingly.

- **Smaller EU companies operating in large international supply chains**

Although smaller companies have no formal obligations, they will still receive data requests from large customers remaining in CSRD-scope. The quality of that data may also determine whether they can retain existing customers, gain a foothold with new ones, or how investors perceive their risk profile. VSME is the best option for this group.



Building a solid data and digital foundation



Numerous new EU regulations — as well as similar regulations in other parts of the world — also require an overhaul of support systems – including assurance, digital systems, and communication strategies. Many companies have started that process, mainly focused on compliance. However, simplified regulations also offer an excellent opportunity to create real commercial value if the support systems are designed correctly. Below are some recommendations for digital and data.

→ Go for scalable digital solutions and choose configuration over customization

Don't pick a digital tool that covers only one regulation but select a platform that can fit in other existing regulations, digest future regulations, and make it easy to respond to ESG ratings. A broad enterprise system also lets you expand into audits, risk, ESG data, and financial integration without having to rebuild it later. Companies should choose to configure the existing modules — or “Lego blocks” — of a software package rather than a customized solution. Configuration can dial in data business needs – such as tailored metrics, digital workflows, and approval hierarchies. Customization often creates future upgrade pain, higher costs, and vendor lock-in.

→ Map internal data custodians and grill potential external digital partners

Success depends on people, not software. Companies must identify internally who owns what data, who will resist, and who will embrace the digital effort, and develop communications, training,

and deployment plans around this. Externally, companies should scrutinize potential software vendors, which often overstate their capabilities. Without due diligence, companies end up with misaligned tools, hidden costs, and data gaps. Since most software vendors have small service teams, it is crucial to bring in additional consulting partners with deep, relevant regulatory and industry knowledge to robustly configure and implement the chosen software solution.

→ Automate data collection and prioritize a stable data infrastructure before deploying AI

Automate repeating workflows and reduce reliance on manual spreadsheets. This will reduce monthly “data chasing,” lower the risk of errors, free up time, encourage adoption, and create reliable, auditable data for regulators, auditors, suppliers, and customers. Automation is a crucial step in building a stable data infrastructure that consistently generates high-quality data. AI can help unlock new ways to leverage data, but companies should first build a stable, high-quality data infrastructure rather than rushing into AI. Without clean data, AI will add noise, errors, and compliance problems.

REGULATION 2

CSDDD: Only big players and big risks

The Corporate Sustainability Due Diligence Directive (CSDDD) is the second major sustainability regulation to reach its final form. Major revisions to its original design have been fully approved and **published in the EU's Official Journal**. Member States have until July 2028 to transpose the changes into national law. Although the CSDDD has lost some of its ambition along the way, it will still cast a bright spotlight on the value chains of large companies. Beyond compliance, value chain due diligence also has business value, helping companies understand and address risks and protect financial value.



Key features of the amended version of the CSRD/ESRS:

Reduced scope	Simplified due diligence	Legal liability	Delayed timeline
<ul style="list-style-type: none">• EU companies with > 5000 employees and > €1.5 billion turnover.• Non-EU companies with a turnover of > €1.5 billion in the EU.• # of companies reduced by 70%.	<ul style="list-style-type: none">• Risk-based approach to identifying & addressing adverse human rights and environmental impacts• Monitoring of adverse effects primarily focuses on Tier 1 suppliers; for indirect suppliers, only plausible info of significant risks requires action.• Transition plans are no longer mandatory.	<ul style="list-style-type: none">• Removal of EU-wide harmonization of civil liability• Lower fines for non-compliance (maximum 3% of the global net turnover).	<ul style="list-style-type: none">• Start of compliance delayed to July 2029.

Acquaint yourself with the foundational standards the CSDDD draws from

Now that the scope and content of the CSDDD are set, your company needs to start moving if it hasn't already. Invest time in understanding the foundational standards behind the directive and their intent and requirements — e.g., the UN Guiding Principles on Business and Human Rights — and get started on the general scoping exercise by focusing on the areas of chains of activities where actual and potential adverse environmental and human rights impacts are most likely to occur, systematically involving stakeholders.

Design a due diligence approach that goes beyond compliance from the start

Develop a broader supply chain due diligence strategy that integrates regulatory obligations with strategic objectives — such as supply chain resilience, quality improvement, commercial readiness, and sustainability ambition — and embed the strategy into corporate governance — including assigning management accountability, updating supplier requirements, and setting up or improving an accessible grievance mechanism for stakeholders to raise concerns.

Leverage requirement overlaps across EU regulations

Leverage activities conducted under CSDDD to also meet requirements under other due diligence legislation — such as the EU Deforestation Regulation (EUDR) and the EU Forced Labor Regulation (EUFLR), or CSRD. For example, consider how scoping and due diligence activities conducted under CSDDD can be used to fulfil CSRD's broader value chain reporting and serve as inputs to the simplified Double Materiality Assessment.

Start preparing now to avoid implementation bottlenecks

Companies should not underestimate the CSDDD's complexity. Those who delay action until 2029 will most likely face challenging implementation pressures, which could result in penalties, supply chain disruptions, and reputational damage. Leading companies are already piloting programs, building supplier capacity, testing grievance mechanisms, and refining prioritization frameworks. Early investment allows iterative learning and positions companies as responsible leaders rather than reluctant compliers.

Don't drop your due diligence efforts because your company is now out of scope

Companies freshly out of scope should continue to mature their environmental and human rights due diligence practices. The purpose of CSDDD wasn't compliance for its own sake, but to improve risk management, transparency, and resilient operations and supply chains. These business needs do not disappear when a company falls out of scope — especially given the large size of many of them. They will still face stakeholder scrutiny and remain subject to other EU due diligence regulations — such as those on deforestation and forced labor, with much lower thresholds. Additionally, many jurisdictions outside the EU are increasing their own mandatory human rights requirements.



Using verified disclosures in communication



→ Leverage verified disclosures and robust data to create credible, defensible narratives

Credible evidence is gold in communication – especially in an era of waning stakeholder trust. In this regard, AI presents both risks and rewards. Stakeholders use AI to check claims for greenwashing. Still, AI is also inclined to present information that can be well substantiated, raising the value of robust corporate data in the public domain — such as sustainability reports. Greenwashing is often rooted in poorly grounded PR — or “spin” — which has material legal, reputational, and financial consequences. However, greenhushing isn’t the answer either: stakeholders demand accountability and tangible proof. Silence creates a vacuum that others will fill, while stealing the advantage of proactive communication. Honesty paired with evidence is the right way to go.

→ Develop a stakeholder-centric communication strategy

Build your organization’s communication strategy around what your stakeholders want to know, not just what your company wants to tell them. Recognize that you have a range of audiences, each with unique aspects they care about concerning your performance and sustainability more broadly. Your starting point should be to step into their shoes, identify their priorities, and frame your story through that lens.

→ Shift the sustainability narrative from compliance to opportunity

Leverage reporting insights – such as financial impact data and risk, impact, and opportunity identification – to shift your corporate sustainability narrative from one focused on cost and compliance to strategic advantage, resilience, and long-term value. This reframing more accurately reflects the priorities of the majority of executives and investors — including competitive positioning, risk-adjusted returns, resource constraints, supply chain exposure, and consumer expectations.

REGULATION 3

EUDR: Switching to pragmatism

The EU Deforestation Regulation (EUDR) – officially in force since late 2023 but not yet applied – bans the import and export of deforestation-linked commodities — such as wood, cocoa, palm oil, coffee, and products containing them — and requires companies to prove that the goods they sell in the EU are deforestation-free. Corporate pushback against the high and costly burden of proof — especially for small companies — has diluted the EUDR. The fully approved changes were published in the EU Official Journal last December. However, a planned EU Commission review could further dilute the EUDR. Still, the direction remains the same: companies have an increasing responsibility to assess their potential links to deforestation.



Key features of the amended version of EUDR:

Company scope	Simplified due diligence	Legal liability	Delayed timeline
<ul style="list-style-type: none"> Any operator – no matter how small – who wants to place EUDR-covered commodities or products on the EU market. 	<ul style="list-style-type: none"> Downstream responsibility has been reduced. Only the first importer of a covered commodity, or product containing it, must submit a complete Due Diligence Statement (DDS). Operators that follow just need a valid DDS reference number. Micro/small enterprises (small, primary producers selling a product in the EU) only have to submit a simplified one-time declaration. Micro = < 10 employees; < €450,000 balance sheet; < €900,000 turnover (2 out of 3). Small = < 50 employees; < €5 mln balance; < €10 mln turnover (2 out of 3). 	<ul style="list-style-type: none"> Maximum fine for non-compliance: 4% of EU turnover for first offenders; increasing percentage for repeat offenders Confiscation of goods violating EUDR and proceeds from goods already sold. Temporary bans on selling goods on EU markets and exclusion from EU public procurement. 	<ul style="list-style-type: none"> Medium/Large-sized enterprises begin due diligence obligations from December 2026. For micro/small operators, compliance will start from June 2027, a year later than planned. The EU Commission will perform a review of Regulation text by April 2026, which could lead to further simplifications.

Start mapping EUDR exposure as soon as possible

Regardless of companies' compliance timelines, they should begin identifying which of their suppliers, products, and geographies will be subject to the EUDR. This is one of the most fundamental tasks in preparing for it. Due to the sprawling complexity of supply chains, this scoping phase alone will already be time-consuming. Without clarity on what is in scope, companies cannot design due diligence systems, procure diligence systems and technology, or understand operational impacts.

Continue preparing, despite the latest EUDR's postponement

Implementing the EUDR is an intense exercise. Companies that have already put the process in motion — mapping products, identifying suppliers in scope, installing supporting software — should continue to do so. Large companies often have tens of thousands of suppliers, so instead of halting the effort, they should use the time to better prepare. Stopping would not only jeopardize compliance-readiness and undermine sunk investment. Work already undertaken is also foundational to meet stakeholder and customer expectations, regardless of regulatory obligations.

You can't rely on data collected for CSRD/ESRS; EUDR requires its own data architecture

Many companies have already invested considerable effort in building data-collection architecture to comply with the CSRD/ESRS. However, these efforts do not provide the information needed for EUDR compliance, as CSRD and EUDR are conceptually and operationally distinct. CSRD focuses on disclosure, not operational due diligence. Companies must therefore build an EUDR-specific data architecture with additional metrics — such as supply chain traceability tools — rather than rely on CSRD reporting systems.

Engage with suppliers to avoid potential disruptions and reputational risks further down the line

Once the EUDR is in force, non-compliant suppliers could cause operational disruption. Products may be stopped at the EU border, which directly affects business continuity and customer expectations. Early supplier engagement helps companies mitigate these risks. Beyond legal penalties, blocked imports, and operational disruptions, companies risk brand damage if they are seen as contributors to deforestation. Brands with high consumer exposure — such as luxury or consumer goods — are particularly at risk of public scrutiny if found non-compliant. Conversely, the more mature ones on that journey enjoy a first-mover advantage by demonstrating commitment and concrete actions to ensure deforestation-free products.

Don't mistake possible EUDR simplification for a change in the direction of travel

A planned simplification review may well lead to changes — including softened thresholds and phasing or simplified obligations for low-risk operators. However, while the political momentum favors simplification and pragmatism, companies still need to carefully monitor supply chains to protect margins, strengthen brand reputation, and mitigate risks. Regardless of the outcome of the review, companies should also not lose sight of EUDR's long-term intent: deforestation-free supply chains for all products marketed in Europe.



Boosting credibility through robust assurance



→ Select an assurance provider that combines assurance capability with sustainability expertise

Choosing the right assurance partner is a critical step in setting up your company for success. An assurer must combine (accredited) assurance capability with a deep understanding of sustainability across climate, nature, and social topics relevant to your company. An assurance partner should also be a good fit for the company's size, nature, and expectations. A technically weak assurer will slow down audits and may misunderstand key disclosures and how topics are managed. A poor cultural fit can create friction.

→ Start early to reduce risk and avoid surprises in your first reporting year

Companies should start preparing for assurance far before the first mandated reporting year. They need to engage an assurance provider early and proactively identify system, data, and process issues through pre-assurance and assurance-readiness activities. Early preparation helps ensure that weaknesses are identified and resolved gradually rather than emerging all at once during the first actual reporting year – recognizing that achieving full maturity still requires multiple years, repeated checks, and cross-functional coordination.

→ Voluntary assurance underpins market credibility and investor trust

If companies are no longer within the scope of regulations — such as the CSRD and CSDDD — they should still consider voluntary limited assurance. Once a subset of companies is subject to mandatory limited assurance, that expectation often trickles down, creating pressure for others to follow suit. It also has clear commercial advantages: external validation of sustainability efforts and green claims underpins market credibility, investor trust, and stakeholder confidence.

CBAM: Pushing the borders

The three-year warm-up phase of the EU carbon border adjustment mechanism (CBAM) is over. Since January this year, non-EU producers of carbon-intensive materials — including steel, cement, and fertilizers — are facing tangible costs. However, as part of the EU Omnibus, CBAM’s rules and scope have also been simplified, massively shrinking the number of importers affected by the regulation. The fully approved amendments were published in the EU Official Journal last October. The share of embedded emissions covered by the revised CBAM starts low but will ramp up to 100% within 8 years. A lesser-known fact about this regulation: EU producers of CBAM materials will be equally affected as non-EU producers. Decarbonization is the only remedy.



Key features of the amended version of CBAM:

Scope shrinks/expands	Default vs actual values	Eased verification	Payment timeline
<ul style="list-style-type: none"> Annual threshold raised to 50 metric tons for most CBAM Goods (steel, cement, aluminum, fertilizers). Electricity and hydrogen retain original thresholds. The revised rules will cover 99% of emissions while exempting 90% of importers. CBAM-declarants must register before March to continue importing CBAM goods while their application is considered. Downstream expansion of CBAM, covering 180 finished /semi-finished products that contain a high percentage of steel or aluminum, is proposed for 2028. Pre-consumer scrap may also be included 	<ul style="list-style-type: none"> Importers/producers can choose between default values or actual values for calculating embedded emissions. Default values for each CBAM material are based on the average of the ten worst-performing countries, plus a punitive markup rising to 30% in 2028. For fertilizers, the markup is limited to 1%. CBAM materials produced in the EU already include EU ETS pricing, so are attributed zero embedded emissions. A carbon price paid by a non-EU producer, if accepted by the EU, can be deducted from CBAM obligations. 	<ul style="list-style-type: none"> Verification of default-based reporting will no longer be needed. Verification of actual values will be required annually, including a mandatory site visit in the first year and at least every two years thereafter. Accredited verifiers can access CBAM registry on behalf of the declarant to ease the verification process. Consultants may also be appointed in support of the process. Verifiers don’t need to be established in the EU and may apply for accreditation in any Member State. 	<ul style="list-style-type: none"> CBAM will use a similar benchmark approach to the EU ETS, with free allocation covering a declining share of benchmark emissions, starting at 97.5% in 2026 and declining to zero in 2034. Emissions not covered by free allocation will be subject to carbon pricing Allocation of free EU allowances to EU producers of CBAM materials will decrease in equal measure. Purchases of CBAM certificates start in 2027 to cover embedded emissions for 2026. Unused certificates will be repurchased. The CBAM certificate price equals the carbon allowance price on the secondary EU ETS market.

Producers: start calculating true emissions to avoid steep default values

To avoid being hit by default values, non-EU producers should study the CBAM's calculation rules and start applying them. This includes developing a monitoring methodology for emissions, understanding the principles of embedded emissions allocation for co-produced materials, and setting up internal control and data processes for eventual verification. If indirect electricity emissions are relevant and producers want to claim green attributes, they should establish power purchasing agreements early.

Importers: start talking to your raw material suppliers to mitigate impact

Importers who wish to use actual rather than default values should start working with their suppliers as soon as possible to ensure their data infrastructure is up to the task and ready for verification. The potential positive effect will ramp up over time as the share of embedded emissions covered by CBAM increases. The potential upside also depends on how far the suppliers' actual emissions are below default values. Over time, the incentive to switch to actual values will increase, as default values will include a higher punitive markup each year and EU carbon allowance prices will continue to rise due to growing policy-driven scarcity.

Non-EU and EU suppliers are equally affected, so keep decarbonizing

Only decarbonization can mitigate the ultimate effects of CBAM. Non-EU producers and importers feel its effects in two ways: the share of embedded emissions covered by CBAM will go up each year, while applying default values will become increasingly costly due to rising punitive mark-ups. Switching to EU suppliers offers no escape. With every expansion of CBAM coverage, EU suppliers lose a corresponding percentage of their free EU ETS — the EU cap-and-trade system — emission allowances, which they must now buy at steadily rising prices.

Importers of finished goods: get ready for the downstream extension of CBAM

With the CBAM extension to consumer products looming, importers of finished goods with high steel/aluminum content — such as cars, washing machines, and industrial machinery — must ask their non-EU suppliers about the origin and proportion of steel/aluminum in their products. To gauge their exposure, importers also need to know whether they can use actual values to calculate embedded carbon. Since finished products from within the EU are similarly affected, switching won't neutralize CBAM's impact.

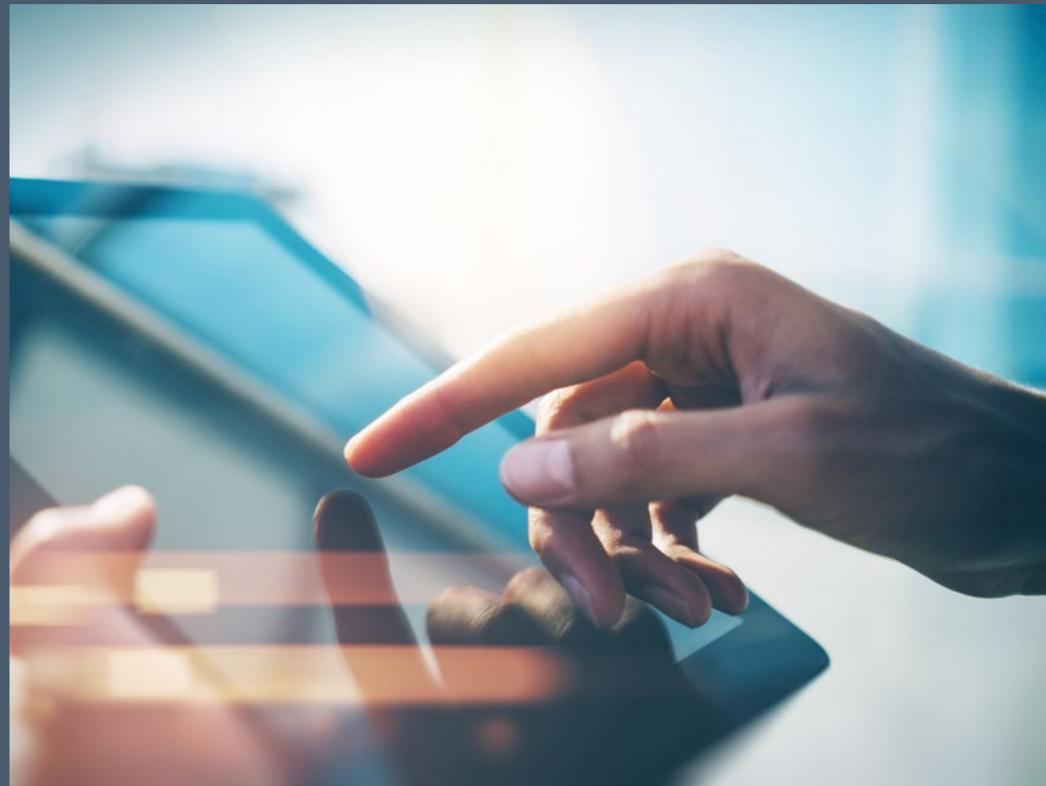
Hedge your future exposure by buying EU emission allowances

Companies can hedge future emission exposure by buying EU emission allowances. The price of CBAM certificates will be equal to the price of EU emission allowances, which are freely traded on the secondary market. CBAM certificates can only be bought through the EU CBAM Registry.

REGULATION 5

SFDR 2.0: Substantial overhaul

The SFDR — which came into effect in 2021 — requires financial institutions to disclose the characteristics of the investment funds and other products they market as sustainable. However, asset managers and investors in financial products criticized SFDR’s complex, vague classifications, fueling confusion on both sides. Now it is up to SFDR 2.0 to provide investors and asset managers with the clarity that the old SFDR failed to deliver. The proposal for a new, simplified structure still has many legislative steps to go through; the European Commission introduced it in November 2025. However, we expect its core concept to survive.



Key features of the SFDR 2.0 proposal:

Company scope	New concept	New product categories	Timeline
<ul style="list-style-type: none"> • EU financial market participants (banks and asset managers) offering sustainability-related financial products. • Non-EU financial market participants marketing sustainability-related financial products in the EU. • The proposed SFDR 2.0 removes financial advisors and portfolio managers for individuals from its scope. 	<ul style="list-style-type: none"> • SFDR 2.0 moves from disclosure-first to a product-first regime with revised sustainability criteria (see next column). • The # of exclusions rises with a fund’s sustainability ambition level. Exclusions include controversial weapons, UN Compact violators, and fossil-fuel activities. • Moves from textually explicit but vague definitions to multiple possible criteria, more closely aligned with broader sustainable finance legislation. 	<ul style="list-style-type: none"> • Non-categorized: financial products without sustainability focus (can still have limited sustainability reference). • ESG Basics: financial products that integrate defined ESG criteria (limited exclusions). • Transition: financial products that support a credible pathway toward sustainability (follows rules/ exclusions included in the EU’s Climate Transition Benchmark). • Sustainable: financial products pursuing a defined sustainability objective (follows rules/exclusions included in the EU’s Paris Aligned Benchmark). • At least 70% of investments must align with stated category objectives. • If >15% of investments align with the EU Taxonomy, a financial product qualifies for the Sustainable or Transition label. 	<ul style="list-style-type: none"> • The timeline for approval of the SFDR 2.0 proposal is unclear, as it is still in the early stages of the EU legislative process. • Despite the early stage and the fact that new Regulatory Technical Standards (RTS) still need to be developed, the core concept is unlikely to change.

The new conceptual SFDR framework is likely to stay

Although the regulatory technical standards (RTS) that will accompany SFDR 2.0 have yet to be drafted, we expect the core classification framework of the new SFDR (ESG Basic, Transition, Sustainability, No Label) to remain unchanged. So, asset managers should start comparing their existing sustainability strategies with the new model, knowing that the conceptual architecture will likely stay the same. Early strategic alignment reduces compliance risk and helps firms to adapt swiftly once technical standards are finalized.

Communicate SFDR-related changes to investors as early as possible

Asset managers can expect to be grilled by investors on how their financial products and stated sustainability commitments align with the revised SFDR framework, long before the new rules take effect. Early communication will reduce confusion, support capital-raising conversations, and demonstrate proactive adaptation to regulatory change. Clear, advanced messaging ensures clients understand how a fund is intended to be classified under the new SFDR and why. This is particularly important for investors in Article 9 products – the most ambitious sustainability category under the old regime – who will expect continuity or a compelling explanation for any shift.

Leverage the expanded possibilities the Transition category provides

Asset managers and investors should revisit their transition finance strategies. Within the old SFDR structure, asset managers focused on “brown-to-green” assets — such as the decarbonization of high-carbon assets — but struggled to position them. They faced a binary choice: either promote narrow ESG characteristics that do not fully reflect the transition ambition or meet 100% sustainability thresholds — which involve complex compliance frameworks — that may limit the investment universe too much. The introduction of the Transition category allows investors to back real-world brownfield decarbonization with clearer expectations and fewer compliance distortions.

Understand the new multi-tier system for choosing sustainability ambition levels

The revised SFDR permits asset managers to choose from several sustainability definitions, while positioning EU Taxonomy alignment as the “gold standard”. The new approach — if approved — would introduce two pathways: asset managers can choose between meeting the 70% alignment threshold for one of the product categories or go for at least 15% Taxonomy alignment — which is deemed the most rigorous evidence of sustainability. Asset managers should factor this new flexibility into their product design, performance storytelling, and internal ESG methodologies.

New financial products should consider new SFDR categories

Because the effective date of the new regime is uncertain, companies preparing new financial products should already examine the new categories. Financial products launched too close to the rule change may miss grandfathering, resulting in reclassification burdens.

Conclusion

After several delays and sudden stops, the EU sustainability regulation and due diligence train is now firmly in motion and will accelerate quickly. Many companies that put preparations on hold a year ago need to get back in gear. Although in many cases the timelines have been extended, companies should use the extra time to prepare for the breadth of regulations – both inside and outside the EU – coming their way, and to ensure their internal support systems and organization are ready to comply with all of them efficiently. Most importantly, early preparation will make the reporting and due diligence process a powerful tool for companies to improve their risk management, identify commercial opportunities, enhance their license to operate, and boost investor confidence.





Authors

Laurent Beuselinck, ERM

Aiste Brackley, ERM

Jacco Kroon, ERM

Johann Weicht, ERM

Contributors

Wayne Fletcher

Nicolas Heath

Roselle Houston

Anna Jakobsen

Gareth Lane

Emily Luscombe

David Neilson

Federica Rosasco

Marine Zimmermann

Design

Siddhartha Ganguly

The ERM Sustainability Institute

The ERM Sustainability Institute is ERM's primary platform for thought leadership on sustainability. The purpose of the Institute is to define, accelerate, and scale sustainability performance by developing actionable insight for business. We provide an independent and authoritative voice to decode complexities. The Institute identifies innovative solutions to global sustainability challenges built on ERM's experience, expertise, and commitment to transformational change.

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