ClientEarth

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Fossil fuels in Article 7 SFDR

Legal risks of financing fossil fuel expansion through EU ‘transition’ funds

Executive summary for EU policymakers

Article 7 SFDR products are intended to invest in companies *“on a credible path to sustainability”* and exclude activities “*commonly agreed to be harmful to the environment and society*”.[1] Trilogue must translate these goals into credible and workable eligibility criteria for fossil fuel companies.

This brief explores the legal, market and investor protection implications of the co-legislators’ divergent approaches to including fossil fuel companies in Article 7.[2] None are perfect.[3] But this brief shows that, **legally, a fossil fuel expansion exclusion is necessary and the minimum viable option** to preserve the “*transparency and integrity*” of Article 7.

Trilogue ask: At minimum, Article 7 must exclude companies engaged in fossil fuel expansion (proposed by the Commission). In addition, it must limit specified coal activities (proposed by Commission and Parliament[4]) and require science-based emissions reduction strategies across all Scopes (not just Scopes 1 and 2 as proposed by Council and Parliament). While this memo focuses on fossil fuel expansion, these additional safeguards remain critical to preserve the integrity of Article 7.

Benefits of excluding expansion: A fossil fuel expansion exclusion would ensure transition-labelled capital flows towards activities consistent with the transition, rather than companies actively undermining it, and deliver legal, regulatory and practical benefits. It would:

- **Align with investor expectations and strengthen investor protection.** An expansion exclusion would reduce the gap between what investors expect a ‘transition’ product to mean and

[1] Commission Proposal, Recitals 12 and 16.
[2] The Commission excludes all fossil fuel expansion and companies deriving ≥1% revenue from coal and requires the phase down of coal for power generation. The Council only requires fossil fuel companies to allocate ≥20% capex to Taxonomy-aligned activities and have a Scope 1 and 2 emissions strategy. Parliament adopts the Council’s position and the Commission’s coal limits, but also requires Taxonomy-aligned capex to exceed fossil fuel expansion. Both Council and Parliament still permit fossil fuel expansion within these constraints.
[3] For example, none require the phase down of all fossil fuel activities or expansion capex to decline over time.
[4] References to ‘Parliament’s position’ refer to the position adopted by the European Parliament’s Committee on Economic and Monetary Affairs (ECON) on 10 September 2026 and subsequently tabled for plenary. At the date of writing, the European Parliament has not yet adopted its formal first-reading position. The ECON position is expected to form the basis of Parliament’s position, subject to any amendments adopted in plenary.

what Article 7 permits, while reducing transition-washing risk by making it harder for products financing fossil fuel expansion to be marketed as contributing to the transition.

- **Align Article 7 with climate science, Paris Agreement goals and wider EU law.** Continued fossil fuel expansion is inconsistent with science-based decarbonisation pathways and the Paris Agreement goals, as recognised in recent developments in EU consumer law.
- **Make Article 7 easier to apply, understand and supervise.** A binary expansion exclusion would provide a simple eligibility test for asset managers, distributors, advisers, investors and supervisors to understand, apply and verify, reducing regulatory complexity, supervisory uncertainty and the scope for inconsistent interpretation.

Risks from the alternative approaches:

- **Supervisory and legal complexity across the investment value chain**. Permissive or complex capex-based tests that permit fossil fuel expansion leave greater scope for inconsistent interpretation and increase the burden on NCAs, asset managers, distributors and investors, who must look behind the Article 7 designation to understand what it means for fossil fuels in practice, and whether criteria have been breached.
- **Transition-washing and investor harm**. Article 7 products could be presented as investing in companies on a credible transition pathway while financing continued fossil fuel expansion. This risks misleading investors and exposes firms to legal risk. Additional criteria requiring fossil fuel companies to have strategies to reduce their Scope 1 and 2 emissions (i.e. neglecting Scope 3) would encourage conduct and communications that ESMA has specifically identified as high-risk examples of greenwashing.
- **Greater MiFID II risk for distributors and advisors**. Retail investors expect transition funds to exclude fossil fuel expanders. If Article 7 doesn't do this, MiFID firms will not be able to rely on SFDR categorisation alone to determine whether clients' sustainability preferences are matched and would need to perform additional due diligence to test the application of capex thresholds and determine whether underlying holdings match client preferences. This would increase the risk of inappropriate recommendations or communications that are unfair, unclear or misleading.
- **Inconsistency with wider EU law**. European courts, consumer authorities and financial regulators have repeatedly scrutinised – and found unlawful – transition and net-zero claims by fossil fuel companies where they obscure or misrepresent continued fossil fuel expansion. Article 7 should not create a transition label that transmits and legitimises company communications that are unlawful under other parts of EU law.

The most legally defensible trilogue outcome is therefore to retain the Commission's fossil fuel expansion exclusion as a legal baseline. If co-legislators instead opt for the ≥20% Taxonomy capex-based approach, it is imperative that they adopt the additional safeguards proposed by Parliament, and ensure emissions reduction strategies apply to all Scopes. The Council's position alone is insufficient.

Further detail is provided in the following pages. To discuss this further contact Sarah Hill-Smith (shill-smith@clientearth.org) and Robert Clarke (rclarke@clientearth.org).

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Legal benefits of excluding fossil fuel expansion from Art 7

ESMA has called for SFDR product categories to contain "*clear, science-based, binding, and measurable"* eligibility criteria, specifically stressing the need for "*legal clarity"* in transition products. The fossil fuel expansion exclusion proposed by the Commission delivers this 'legal clarity' in three ways:

1. Expansion exclusion aligns with investor expectations

BEUC reports that 71% of consumers interested in sustainable finance want investments that "*transition high-emission sectors towards sustainability*" and 62% of European consumers expect sustainable or green products to exclude companies expanding fossil fuels. French polling similarly found that 60% of respondents consider fossil fuel development incompatible with 'responsible' investment and 64% thought 'responsible' funds investing in such companies were greenwashing. At the same time, demand for EU transition funds is substantial and growing.[5] An expansion exclusion in Article 7 is the most legally robust way to match investor expectations and give them a sufficiently clear indication that transition-labelled products finance companies *genuinely* moving away from high-emitting activities.

2. Expansion exclusion is aligned with climate science, Paris Agreement goals and EU law

The IPCC concludes with high confidence that limiting warming "*requires shifting energy away from fossil fuels*" (p.85) and that emissions from existing and planned fossil fuel infrastructure would greatly exceed the carbon budget for 1.5°C (p.68).[6] Similarly, UNEP found recently that planned fossil fuel production in 2030 remains "*more than double*" the level consistent with 1.5°C, and that meeting the Paris Agreement goals requires cutting fossil fuel production "*to the very lowest levels possible*". Against this backdrop, continued investment in fossil fuel production and expansion actively undermines the transition and cannot be reconciled with a product category intended for companies on a 'credible transition pathway'. Relevant precedent on this has been set in European consumer law (see below).

3. Expansion exclusion is easier to apply, understand and supervise

A binary exclusion of fossil fuel expansion would also be simpler for all financial market participants (FMPs) to use than comparatively complex, capex-based, criteria. Given the availability of public databases and tools,[7] it would be easier for asset managers to apply, distributors and financial advisors to verify, regulators to supervise without reconstructing company-level capex calculations, and easier for retail investors to understand.

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[5] Morningstar and Sustainalytics report that in H1 2025, EU transition funds: represented 54% of all European climate funds; grew by 16% to USD 23bn AUM, with 120 new funds; and were the only climate fund category to attract inflows (of USD 1.6 billion). Sustainable funds remained "*in positive territory*" in Q2 2026.

[6] Studies show that a large share of existing fossil fuel reserves must not be extracted to keep Paris Agreement goals alive. See: Welsby et al, Unextractable fossil fuels in a 1.5°C world, *Nature* (2021); Trout et al, Existing fossil fuel extraction would warm the world beyond 1.5 °C, *Environmental Research Letters* (2022).

[7] For example, public databases like Urgewald's Global Oil & Gas Exit List and Global Coal Exit List, which ESMA (p.8) and the AMF (p.43) have used for research and to identify companies developing new fossil fuel projects.

Legal and regulatory risks of alternative proposals

The practical effect of the Council and Parliament positions

The Council and Parliament proposals are materially more complicated and permissive, giving rise to heightened legal risk. The Council would permit fossil fuel companies, including those developing new projects, in Article 7 funds, provided they allocate >20% of total capex to Taxonomy-aligned activities and have a time-bound and measurable, 'Paris-compatible' strategy to reduce Scope 1 and 2 emissions.

Parliament's approach is significantly stronger than Council's, and for that reason should be preferred should an outright expansion exclusion not be adopted. In addition to the Council's criteria, it adopts the Commission's restrictions on coal (including a requirement to phase down coal for power generation) and requires fossil fuel expansion capex to be lower than Taxonomy-aligned capex, recognising the importance of a company's investment in fossil fuel expansion to the credibility of its transition pathway.

However, both positions ultimately remain insufficient to fully meet investor expectations and protect the integrity of Article 7. Neither proposal excludes fossil expansion outright or requires expansion capex to be reduced over time,[8] and (given the omission of Scope 3 from emissions reduction requirements) neither requires a comprehensive phase down of existing fossil fuel activities (including oil and gas) across the value chain. The practical result is that a company could maintain and expand its fossil fuel activities, while qualifying for an EU-regulated transition category, giving rise to the following legal risks.

1. Supervisory challenges and misinterpretation along the investment value chain

Under the more permissive and complicated capex-based proposals, supervisors and FMPs may need to reconstruct underlying eligibility and company-level capex calculations simply to understand what the Article 7 designation means, and whether it has been complied with, in practice.

ESMA has already warned of "*further challenges*" for NCAs supervising compliance with SFDR eligibility criteria alongside disclosure obligations (para 73). Compared to a clear expansion exclusion, permissive capex-based criteria exacerbate these concerns. To assess compliance, regulators would need to review and test capex calculations against company reporting that is not always uniform in practice, and data availability may be another limitation. This may impede effective enforcement and give rise to divergent supervisory approaches across the EU.

Moreover, asset managers and investment firms must determine eligibility; distributors, advisors and portfolio managers must understand the resulting product characteristics sufficiently to inform client recommendations; and investors must be able to understand what Article 7 classification signifies. The more complex and permissive the eligibility test, the greater the scope for misapplication and inconsistent interpretation, and the greater the possibility that a technically compliant classification produces an economic outcome inconsistent with an investor's understanding of transition.

[8] As proposed by earlier texts, e.g. the 7 July compromise text which would have required companies to reduce expansion capex by 10 percentage points over three-year rolling periods until it reaches zero.

2. Transition-washing and investor harm

Fundamentally, permitting fossil fuel expansion risks embedding transition-washing in Article 7 itself,[9] misleading investors and exposing asset managers and FMPs to legal liability. An Article 7 product could be marketed as investing in companies "*on a credible path to sustainability*" while holding companies allocating significant capital to new and existing fossil fuel projects, contrary to both investor expectations and global climate goals (see above). Investors and other stakeholders may seek redress through legal claims or regulatory complaints against investment firms and distributors, and liability may follow if investor communications are found to be unclear, unfair or misleading, or to breach other requirements.

Certain proposals give rise to more specific greenwashing risks. For instance, a supposed safeguard proposed by the Council and Parliament would require for fossil fuel companies to maintain a "*time-bound and measurable"* Scope 1 and 2 emissions reduction strategy compatible with the Paris Agreement. Two greenwashing risks arise. First, fossil company emissions reduction plans that neglect Scope 3 cannot be considered Paris-aligned.[10] Second, this approach endorses a form of "*high risk*" greenwashing that ESMA has specifically warned against through the example of a diversified oil and gas company whose emissions target does not cover Scope 3. Because Scope 3 comprise the vast majority of fossil fuel extraction emissions, ESMA says this "*appears misleading for investors*" (para 73).

ESMA has also identified high greenwashing risk where there is a "*disconnect between climate disclosures*" and companies' "*actual conduct*", specifically highlighting the risks of fossil fuel companies making net zero commitments "*while continuing to invest in expanding fossil fuel supply*" (para 74). SFDR must not give regulatory endorsement to precisely the behaviour and characteristics that ESMA has identified as greenwashing. This could be avoided by a clear expansion exclusion in Article 7.

3. Increased MiFID II exposure for advisors and distributors

Article 7 also has direct consequences for firms manufacturing, distributing and recommending financial products under MiFID II. The SFDR II's product categories are expected to create a "*coherent set of EU rules for all ESG-focussed products*" and "*help distributors identify the products that match their clients' sustainability preferences and perform their target market assessment*".[11]

Article 7 therefore needs to operate as a sufficiently reliable regulatory signal. The more permissive or complicated its criteria become, the less safely MiFID distributors and advisors can rely on Article 7 classification alone as a proxy for their clients' 'transition' preferences, and the greater the risk that they fail to match suitable products with those preferences. Without a clear expansion exclusion, firms may need to conduct additional diligence on individual fund holdings before concluding that a transition product is suitable for such a client, making SFDR classification less useful as an investment tool.

This may also increase risk that firms fall foul of the MiFID requirement that communications to clients are "*fair, clear and not misleadin*g" under Article 24(3), by transmitting transition-washing baked into the

[9] See analysis and evidence of transition-washing risk in ClientEarth response to SFDR call for evidence (30 May 2025), paras 2-11, and 13; and ClientEarth feedback on Commission SFDR II proposal (5 April 2026), paras 18-24.
[10] Relatedly, in June 2026, a Paris court found that TotalEnergies' vigilance plan was incomplete because it excluded Scope 3 emissions, which comprise 90% of its emissions. See *Notre Affaire à Tous et al. v. TotalEnergies SE* (English translation here) paras 163-164, 168, 182-183, 206-209 and 221.
[11] Commission Proposal, Recital 13 and Explanatory Memorandum, section 3 'impact assessments'. The Commission's SFDR Impact Assessment Report calls for "*perfect alignment*" between SFDR product disclosures and MiFID sustainability preferences, and for distributors to integrate SFDR categorisation into their processes.

SFDR transition fund (through the inclusion of non-transitioning companies) to their clients. An SFDR classification does not remove the responsibility under MiFID for firms marketing and distributing even technically compliant Article 7 products to ensure their own communications do not create a misleading impression as to the product's transition characteristics. A clear expansion exclusion would simplify suitability assessments and give MiFID firms greater confidence in the Article 7 label.

4. Inconsistency with wider EU law

Permitting fossil fuel expansion in Article 7 creates avoidable inconsistency with wider EU law. Climate and transition claims by fossil fuel companies have been declared unlawful under consumer law where they overstate transition credentials despite continued investment in fossil fuel use and expansion.

In October 2025, a Paris Court found that TotalEnergies made a claim "*likely to mislead consumers"* by presenting purchases of its products and services as "*participating in the emergence of a low-carbon economy*" aligned with science and the Paris Agreement.[12] Its continued investment in oil and gas was one of the reasons this was misleading.[13] In June 2026, BEUC and various EU consumer agencies filed complaints concerning similarly misleading net zero and transition claims made by TotalEnergies and other fossil fuel companies "*despite continuing to invest heavily in fossil fuel expansion*". Comparable scrutiny is building in relation to company communications to investors.[14]

There is a developing legal expectation that broad transition claims are assessed against the company's complete business model and strategy, including continued fossil fuel expansion, and not selectively on low-carbon investments or operational emissions reductions. This must be respected in Article 7.

The Council and Parliament texts would undermine this position: a fossil fuel expander could be eligible for Article 7 'transition' products, while facing enforcement action or litigation for transition-washing in its own communications. This would create unnecessary legal and regulatory dissonance between the SFDR and other areas of EU law, making it hard for courts and regulators to navigate SFDR, and generating legal uncertainty for FMPs and investors dealing with Article 7 products. The expansion exclusion proposed by the Commission, coupled with robust coal phase-down and emissions reduction requirements, is the strongest Trilogue outcome to reduce this tension, promote greater coherence across EU law and make it easier for financial market participants to govern their own legal risk.

If the Commission's blanket expansion exclusion is not adopted, co-legislators should at the very least opt for the Parliament's additional requirements for Taxonomy capex to exceed expansion capex, and address remaining gaps by requiring companies to reduce expansion capex to zero over time and ensuring that emissions reduction strategies apply to all scopes. The Council's position alone is insufficient to deliver the objectives of the regulation.

[12] *Greenpeace & Ors v. TotalEnergies SE & Ors* (23 October 2025), para 130. English translation here.
[13] Greenwashing decisions also impact other high-emitting sectors like aviation. See: *Fossielvrij & Reclame Fossielvrij v KLM* (2024); and EU airlines commit to stop potentially misleading climate-related claims (2025).
[14] See e.g. investor and NGO complaints to Norwegian and French financial regulators alleging misleading investor statements by Equinor (Sept 2025) and TotalEnergies (May 2026) in light of continued hydrocarbon production; and an NGOs' letter urging ESMA to strengthen greenwashing scrutiny in investor communications (May 2026).