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What’s in a Name?: “Defense Stocks” Highlight the Challenges for Asset Managers in Navigating Sustainability Taxonomies as They Characterize Investments as ESG-Compliant

Article By:

Jason M. Halper

Ellen Holloman

Sara Bussiere

Timbre Shriver

Jayshree Balakrishnan

It is hardly news that ESG investing is a significant aspect of the asset management industry. According to Barron’s, $400 billion was invested in U.S. mutual funds and assets that have an ESG orientation in 2021.[1] However, it remains a challenge for issuers, asset managers, regulators and other industry participants to determine whether a particular business, industry, or product promotes or is harmful to ESG considerations. The Russian invasion of Ukraine shines a spotlight on this larger issue due to shifting attitudes about “defense stocks”—*e.g.*, stock in weapons and ammunition manufacturers and other companies in the defense industry. The defense industry does not immediately come to mind when thinking about ESG issues. From an environmental perspective, weapons production has a high carbon footprint.[2] Conservative estimates place national defense at more than 50 percent of governments’ carbon emissions.[3] From a social perspective, defense spending has historically been viewed as contrary to social good and welfare.[4] But in light of recent events, public opinion, even viewed through the ESG lens, has seemed to shift away from the potentially harmful environmental impact of the industry towards the potentially positive social impact it may have in the defense against a harmful geopolitical actor.[5] Analysts suggest that “defense is likely to be increasingly seen as a necessity that facilitates [ESG] as an enterprise, as well as maintaining peace, stability and other social goods.”[6]

The notion that a particular business or product can give rise to tension between the environmental and social aspects of ESG, or raise disputes about whether it is sustainable or socially beneficial at all, is not limited to the defense industry. For instance, in the United States, there have been significant investor complaints and confusion, as well as regulatory scrutiny surrounding the question of what constitutes a "sustainable" company.[7] Just ask Oatly, a Swedish oat milk producer and self-described sustainable company that faced significant backlash and was "cancelled" on social media after it sold a significant equity interest to a high-profile group of investors led by a private equity firm whose portfolio also includes investments in corporations accused of contributing to climate change and other unsustainable practices.[8] Though Oatly applies sustainable practices in its production process,[9] environmental activists, including some shareholders, argued that Oatly was doing more harm than good to overall sustainability by accepting these investments. However, as discussed below, this type of black and white approach does little to help assess whether a particular investment is consistent with ESG principles. Rather, ESG investing requires far more nuanced assessments that take into account, among other things, the managers' historical statements about its ESG investing approach, the investors' particular ESG appetite, and taxonomic classifications of the product or business. From the perspective of the private equity firm that invested in Oatly, investment in a sustainable brand could signal that sustainability can be profitable. Likewise, the defense industry illustrates the difficulties in taking a "one-size-fits-all" approach to classifying companies or products as "ESG-compliant" or not. Another example is natural gas, which, under certain circumstances, was classified as green in the EU Taxonomy Regulation (the "EU Green Taxonomy"), raising protests from various quarters about this classification. But in justifying its decision, the European Commission pointed out that "there is a role for natural gas and nuclear as a means to facilitate the transition towards a predominantly renewable-based future."[10] Thus, while there are any number of examples, the defense industry provides a useful lens through which to examine the challenges for the asset management industry in classifying investments as sustainable or not.

Defense Stocks in the EU Taxonomy

What the Bill Proposes

As discussed in our previous article, [Investors and Regulators Turning up the Heat on Climate-Change Disclosures: Attempting to Make Sense of the State of Play in the US, EU, and UK], the EU's Taxonomy Regulation (the "EU Green Taxonomy"), which was published in June 2020, introduces an EU-wide taxonomy of environmentally sustainable activities in order to help the EU achieve its goal of carbon neutrality by 2050.[11] It sets up "a classification system, establishing a list of environmentally sustainable economic activities" to facilitate investment in sustainable businesses,[12] but the EU Green Taxonomy does not purport to regulate business activities. Instead, it is a tool to encourage private investment and facilitate the achievement of the EU's climate-related goals. In order to do so, the EU Green Taxonomy "provides that these economic activities should comply with the technical screening criteria set out in the delegated acts adopted by the Commission."[13] This flexible approach establishes a basic framework for sustainable activities and identifies key objectives to further the EU's path to carbon-neutrality, unlike the taxonomies of other jurisdictions, explained below, that strictly whitelist permissible "green" activities. As an added layer of flexibility, it lays out not just low-carbon activities but also transitional and enabling activities. Transitional activities are those that "cannot yet be replaced by technologically and economically feasible low-carbon alternatives, but do contribute to climate change mitigation and with the potential to play a major role in the transition to a climate-neutral economy, in line with EU climate goals and commitments, and subject to strict conditions, without crowding out investment in renewables."[14] Asset management firms are afforded flexibility in the green activities they incorporate into their portfolios in that they are not limited only to low- or zero-carbon economic activities. For instance, some firms are leveraging the Green Taxonomy to attract "the most discerning ESG clients" by developing funds that include only products that rank sustainability as their very top priority.[15] On the other end of the spectrum are investment firms that take a more flexible approach to permissible ESG-compliant investments.[16]

On February 2, 2022, the EU approved in principle the Complementary Climate Delegated Act (the "Delegated Act"), the third delegated act supplementing the EU Green Taxonomy.[17] Under the Delegated Act, natural gas and nuclear energy fall into the EU Green Taxonomy's "green" bucket under certain conditions as qualifying transitional activities. The qualifying natural gas activities include electricity generation, high-efficiency co-generation of power and heat/cool, and production of heat/cool in efficient district heating and cooling systems from fossil gas.[18] The qualifying nuclear energy activities include the research, development and deployment of advanced technologies that minimize waste and improve safety standards, new nuclear plant projects with existing technologies for energy generation of electricity or heat, and upgrades and modifications of existing nuclear plants for lifetime extension purposes.[19] While the Delegated Act does not address defense stocks directly, the increased flexibility in the EU's plan to achieve carbon-neutrality (by broadening the scope of transitional activities under the EU Green Taxonomy to include natural gas and nuclear energy) signals a broader understanding of what activities are permissible or necessary for climate change transition and therefore compatible with a sustainable investing approach. Defense stocks—often excluded from ESG portfolios—could be viewed as engaging in sustainable activities for multiple reasons. First, many defense companies are attempting to reduce their carbon footprint, starting with internal operations and energy usage.[20] In fact, the UK Ministry of Defence and top defense officials in the U.S. have emphasized environmental sustainability for the armed forces and defense contractors,[21] and major European defense firms recently issued a joint statement arguing for recognition of the defense industry as a sustainable actor.[22] Second, some commentators have stated that sustainability depends on "the open values of democracy" which require protection afforded by the defense industry.[23]

Despite the conditions imposed on natural gas and nuclear energy activities in order to be considered sustainable,[24] critics have argued that the Delegated Act tarnishes the goals of the EU Green Taxonomy and promotes greenwashing.[25] The inclusion of natural gas was particularly contentious because continued natural gas production and use is contrary to the International Energy Agency's Net Zero recommendations,[26] which advise that there must be no investments in new fossil fuel projects and gas plants must be shut down by 2035 in industrialized countries in order to restrict increases in global temperatures to 1.5 °C. [27] Nuclear energy, though helpful to climate change mitigation, is associated with risks related to the storage of nuclear waste, accidents at nuclear plants, and nuclear proliferation. These other environmental and social concerns suggest nuclear energy may not be consistent with the EU Green Taxonomy's do no significant harm ("DNSH") principles.[28] While the Delegated Act was under review, the EU's Platform on Sustainable Finance (the "SF Platform")[29] suggested the Delegated Act would pose "a serious risk of undermining the sustainable Taxonomy framework."[30] The SF Platform criticized the Delegated Act for taking a "materially different approach" to the EU Green Taxonomy by "focusing on energy technologies that are part of an energy system in transition but do not in themselves reach the substantial contribution levels required for the Paris Agreement or fulfill the DNSH performance requirements."[31] The SF Platform also identified many inconsistencies between the Delegated Act and the principles and objectives of the EU Green Taxonomy.[32]

Although the Delegated Act was approved in principle, it faces significant resistance, as many organizations continue to fight against the inclusion of natural gas and nuclear energy into the EU Green Taxonomy.[33] EU member nations such as Germany, Austria, Luxembourg and Spain have all suggested legal action against the Delegated Act.[34] Germany is considering a legal challenge based on the legal form of the Delegated Act.[35] Austria and Luxembourg are preparing to bring a suit, which Spain may join, before the European Court of Justice, claiming that including nuclear energy in the

Delegated Act violates the EU Green Taxonomy's DNSH principles.[36] Spurred on by Russia's invasion of Ukraine, 102 lawmakers in the European Parliament have asked the European Commission to withdraw the Delegated Act—especially in light of major European countries and the European Commission itself announcing plans to withdraw energy dependence on Russian gas.[37]

The EU Social Taxonomy

The Platform published its final report on the proposed EU Social Taxonomy on February 28, 2022.[38] The EU Social Taxonomy would complement the EU Green Taxonomy by establishing guidelines that focus on the development of social objectives, types of substantial contributions to climate change mitigation, DNSH principles, and minimum safeguards.[39] Unlike the EU Green Taxonomy's six defined environmental objectives,[40] the EU Social Taxonomy enumerates three main social objectives: decent work, adequate living standards and wellbeing for end-users, and inclusive and sustainable communities and societies.[41] The EU Social Taxonomy also promotes the development of sub-objectives, such as "health and safety; healthcare; housing; wages; non-discrimination; consumer health; and communities' livelihoods."[42] The goal of the guidelines would be to prevent "social washing"—a danger comparable to greenwashing.[43] Social washing refers to misrepresentations made by a company that make the company appear more socially responsible than it is.[44] Similar to greenwashing, social washing can lead to legal liabilities and shareholder pushback for companies. This can happen intentionally or unintentionally from a lack of awareness or lack of defined socially-conscious standards. While the EU Social Taxonomy is not yet final, the report identifies several potential impacts it seeks to promote: "more effective human-rights processes across economies, with measurable positive impacts and real outcomes for workers, consumers and communities throughout the value chain," "capital might flow to activities which contribute to improving access to products and services that improve standards of living and access to basic economic infrastructure," improvements to global housing crises, and increased global connectivity.[45]

Just as the EU Green Taxonomy uses DNSH principles to exclude those activities that in no way would be compatible with its environmental objectives, the EU Social Taxonomy proposes excluding certain activities as significantly socially harmful based on two sources: (1) internationally agreed-upon conventions; and (2) research into the detrimental social effects of certain activities. Interestingly, the proposed EU Social Taxonomy identifies weapons—such as chemical and biological weapons, anti-personnel mines, cluster munitions, and nuclear weapons—that are governed by international treaties as potentially harmful activities (as opposed to classifying such weapons as per se antithetical to social good).[46] This is a change from a draft report in February, which identified all weapons as significantly harmful and ideal for exclusion from social investments.[47] The rapporteur of the Platform responsible for the report deemphasized this change, stating that it was due to a lack of precision in the language of the exclusion.[48] Others speculate that the reference was omitted due to defense lobbying.[49] Despite the change, however, the rapporteur maintains that weapons could not qualify as social goods because they do not promote human rights.[50] Meanwhile, proponents of including weapons in a social taxonomy caution against a wholesale exclusion of the defense industry and argue that defense is integral to a socially sustainable society.[51]

Defense Stocks in Other Taxonomies

ESG regulations and guidance vary in scope and approach globally. This only adds to the challenges facing investors and fund managers looking to add defense stocks to their ESG portfolios. Those who consider integrating defense stocks into ESG funds, or stocks in other industries that are not clearly considered sustainable or socially beneficial, should consider the guidance in each country in which they conduct business.

1. **China:** The Green Bond Endorsed Project Catalogue (the "Catalogue") is China's approach to sustainable investing, although it is more narrow in that it is focused on green finance.[52] China does not have a social taxonomy yet. Unlike the flexible guidelines for private investors under the EU Green Taxonomy, China takes a binary approach by maintaining a detailed "white list" of sustainable activities.[53] All green bond issuers that solicit investors both in China and internationally must adhere to China's taxonomy.[54] Green bonds are defined as "marketable securities that use raised funds specifically to support green industries, green projects, or green economic activities that meet specified conditions."[55] Notably, the Catalogue does not include natural gas or defense stocks in the permitted green bond categories, but does include nuclear energy. Just as with the EU Green Taxonomy, the Catalogue follows DNSH criteria.[56] China and the EU published a joint analysis of both the Catalogue and the EU Green Taxonomy, the Common Ground Taxonomy.[57] While not a legally binding document, it does indicate that China will cooperate with the EU on sustainable finance issues.

2. **South Korea:** The K-Taxonomy was adopted in December 2021 and addresses sustainability measures only, not social sustainability. Similar to the EU Green Taxonomy, it provides standards and guidance on green activities.[58] The K-Taxonomy includes liquefied natural gas—at much higher levels than the Delegated Act—but omits nuclear energy.[59] The K-Taxonomy appears to be heavily influenced by the EU Green Taxonomy, including in that it follows a similar structure and incorporates the concepts of "substantial contribution" to climate objectives, DNSH, and minimum safeguards.[60] Therefore, any policies adopted in the future by the EU may also come to be incorporated into the K-Taxonomy.[61]

3. **South Africa:** The Green Finance Taxonomy is aimed at revitalizing South Africa's economy and achieving low carbon goals.[62] Natural gas is recognized as a transition fuel to achieve decarbonization goals, but has been removed from the final published taxonomy and instead has been reserved for a future "transition taxonomy."[63] South Africa's standards are heavily influenced by international trends and there are plans to expand to a social taxonomy.[64] Any major future policies adopted by jurisdictions like the EU, China and the U.S. could be incorporated by South Africa as well.

4. **United States:** The U.S. has not yet issued formal guidelines or taxonomies on either environmentally or socially sustainable investing. The Securities and Exchange Commission is currently considering far-reaching climate-related disclosures requirements.[65] Key provisions in the proposed rule include disclosure requirements for: oversight and governance of climate-related risks by a registrant's board and management; material impact of climate-related risks; how climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook; any process for identifying, assessing, and managing climate-related risks; potential impact of climate-related events and transition activities on the line items of a registrant's consolidated financial statements and related expenditures; scopes 1 and 2 greenhouse gas emissions metrics, both broken out by constituent greenhouse gases;[66] scope 3 greenhouse gas emissions metrics, if material, or if the registrant has set a greenhouse gas emissions reduction target or goal that includes its Scope 3 emissions;[67] and the registrant's climate-related targets or goals, and transition plan, if the registrant has one.[68] The proposed rule cites the EU Green Taxonomy as helpful guidance. We anticipate that other U.S. financial regulators could announce their own initiatives in the coming months.

Takeaways

1. **There is no consensus on whether certain products or industries qualify as sustainable or socially positive:** This is particularly relevant in the asset management industry, where the lack of consensus in this area creates uncertainty about whether certain stocks are appropriate for ESG funds or even funds that are not ESG-specific but are touted as having certain ESG characteristics.

Exclusionary approach: Critics suggest pushing defense stocks as ESG is counterintuitive and opportunistic given that the debate around the defense industry arose in connection with the Ukraine-Russia conflict. Some argue that when the "purpose is warfare, which—setting aside a wealth of important moral questions—has no clear positive social outcomes" the company cannot be categorized as ESG-positive.[69] If investment firms take an exclusionary approach to ESG investing, thereby divesting funds of all stocks in particular industries, they may choose to exclude defense stocks from their portfolios. A 2018 study lists weapons as the most common exclusion from sustainable and responsible investment portfolios.[70] One advocacy group has set up a website specifically to help investors demilitarize their portfolios.[71]

Integrative approach: From a holistic perspective, however, a defense company that produces weapons could be included in an ESG portfolio if it simultaneously has a strong focus on environmental sustainability and corporate governance, and depending on the asset manager's disclosure about its investment approach and views on the relative social merits of defense stocks. This would be more likely in asset management firms that use an integration approach.[72] Defense companies have been attempting to go green for some time, starting with internal operations and energy usage.[73] As regulators around the globe continue to work to promulgate ESG standards, the defense industry has been advocating for recognition as a sustainable actor.[74]

Ultimately, the suitability of such an investment will turn on a number of factors, including the asset manager's prior statements regarding investment approach; continued development of accepted taxonomies and/or the development of a consensus in the U.S.; and investor appetite for a portfolio including stocks in the industry in question. Asset managers could consider tailored or bespoke portfolios in order to accommodate a variety of investor demands.

1. **ESG policies should be nimble as frameworks evolve:** Global attitudes towards defense stocks are changing, and some investment firms are already taking action. For example, one Swedish financial-services company has recently begun incorporating defense stocks into its funds. Skandinaviska Enskilda Banken AB ("SEB") permits six of its funds to invest in companies that generate more than five percent of their revenue from the defense industry.[75] The reason for this change? According to SEB, "investments in the defense industry are of key importance to uphold and defend democracy, freedom, stability and human rights."[76] In Germany, lenders were cutting off defense firms due to ESG concerns as recently as January 2022, but have changed course given the German Chancellor's announcement of a major increase in defense spending in February 2022 in response to Russia's invasion of Ukraine.[77] In the U.S., polls indicate that the majority of Americans currently view defense spending as a social good.[78] Defense stocks have surged in recent weeks as many countries have increased their defense spending in response to the war and sent weapons to aid Ukraine.[79]

The treatment of defense stocks demonstrates the absence of consensus around taxonomic questions involving certain industries or products. The current scope of the EU Green Taxonomy and the debate surrounding the Delegated Act only serve to highlight the limitations of adopting a narrow approach to ESG investing: focusing on environmental sustainability without simultaneously considering social objectives may decrease motivation to engage in sustainable finance and exclude certain organizations or industry sectors from investors.[80] As the landscape continues to evolve, important considerations include the jurisdiction's sustainable investment guidance and the timeframe the jurisdiction has outlined to achieve sustainability objectives. Policy factors to evaluate include: whether the jurisdiction takes a narrow or broad view of sustainability, whether the jurisdiction supports or frowns upon transitional activities, whether the jurisdiction's taxonomy use flexible or whitelist structure, and whether the country has adopted the DNSH approach.

1. **Consider the role of ESG mitigators versus ESG enablers:** The Delegated Act reflects a broader perspective on sustainability measures. The EU Green Taxonomy includes limited natural gas and nuclear energy activities as transitional activities to decarbonization.[81] According to the Delegated Act, transitional activities are those that "cannot yet be replaced by technologically and economically feasible low-carbon alternatives, but do contribute to climate change mitigation and [have] the potential to play a major role in the transition to a climate-neutral economy."[82] Thus, instead of facing strict exclusionary criteria, private investors have been given one more tool to progress along the path to carbon neutrality. A similar broad perspective could leave room for defense stocks to be incorporated into green portfolios. One commentator suggests there are two types of "good" ESG firms: mitigators and enablers. Mitigators are those that neatly fall under ESG taxonomies—*g.*, those that reduce their own emissions, give back to local communities, and have diverse boards and equal pay among executives. Enablers are those that "provide products and services that support other companies and activities."[83] In this vein, defense stocks could be included in ESG investing as enablers to other types of investments that mitigate climate risks and social harms.

2. **Beware of "social washing":** As discussed in our previous articles, without uniform data standards and ESG ratings systems, each company must adopt a method to calculate and track its environmental and social impact and associated risks. As a result, there is likely to be inconsistent reporting regarding defense stocks and resulting difficulty making effective comparisons between and among companies in the same industry.

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