

# Clients & Friends Memo

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

May 19, 2022

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.<sup>1</sup> 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.<sup>2</sup> Conservative estimates place national defense at more than 50 percent of governments' carbon emissions.<sup>3</sup> From a social perspective, defense spending has historically been viewed as contrary to social good and welfare.<sup>4</sup> 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

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<sup>1</sup> Lauren Foster, *ESG Fund Assets Soared in 2021. They Still Have Room to Run.*, BARRON'S (Mar. 30, 2022, 10:00 am EST), <https://www.barrons.com/articles/esg-fund-assets-soared-in-2021-they-still-have-room-to-run-51648590122>. Globally, Bloomberg Intelligence estimates that ESG assets will reach \$41 trillion by the end of 2022. See Saijel Kishan, *ESG by the Numbers: Sustainable Investing Set Records in 2021*, BLOOMBERG (Feb. 3, 2022, 11:03 AM EST), <https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021>.

<sup>2</sup> See generally Neta C. Crawford, *Pentagon Fuel Use, Climate Change, and the Costs of War*, WATSON INST. BROWN UNIV. (Nov. 13, 2019), <https://watson.brown.edu/costsofwar/files/cow/imce/papers/Pentagon%20Fuel%20Use%20C%20Climate%20Change%20and%20the%20Costs%20of%20War%20Revised%20November%202019%20Crawford.pdf>.

<sup>3</sup> Harry Bowcott, et al., *Decarbonizing defense: Imperative and opportunity*, MCKINSEY & COMPANY (July 1, 2021), <https://www.mckinsey.com/industries/aerospace-and-defense/our-insights/decarbonizing-defense-imperative-and-opportunity>.

<sup>4</sup> Merryn Somerset Webb, *Are defence stocks now ESG?*, FINANCIAL TIMES (Mar. 4, 2022), <https://www.ft.com/content/9073a69f-bc90-4944-b9d9-d2a0a2ff1f15>.

positive social impact it may have in the defense against a harmful geopolitical actor.<sup>5</sup> 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.”<sup>6</sup>

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.<sup>7</sup> 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.<sup>8</sup> Though Oatly applies sustainable practices in its production process,<sup>9</sup> 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.

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- <sup>5</sup> Ed Ballard, *Sweden’s SEB Changes Course on Defense Stocks as War Tests ESG Rules*, THE WALL STREET JOURNAL (Mar. 2, 2022), <https://www.wsj.com/articles/swedens-seb-changes-course-on-defense-stocks-as-war-tests-esg-rules-11646253384>.
- <sup>6</sup> Jeff Sommer, *Russia’s War Prompts a Pitch for ‘Socially Responsible’ Military Stocks*, NY TIMES (Mar. 5, 2022), <https://www.nytimes.com/2022/03/04/business/military-stocks-russia-ukraine.html/>.
- <sup>7</sup> See Jason Halper et al., “Sustainable” Companies Face Increased Pressure to Justify the Sustainability Label Amid Investor Challenges and Demands for Greater Risk Assessment and Disclosure, Cadwalader, Wickersham & Taft LLP (Dec. 1, 2021), <http://www.cadwalader.com/resources/clients-friends-memos/sustainable-companies-face-increased-pressure-to-justify-the-sustainability-label-amid-investor-challenges-and-demands-for-greater-risk-assessment-and-disclosure>; Katherine Dunn, *Oatly learns that it’s not easy being ‘green’*, FORTUNE MAGAZINE (Oct. 11, 2021, 6:30 AM EST), <https://fortune.com/2021/10/11/oatly-oat-milk-green-climate-change-shareholders/>.
- <sup>8</sup> Katherine Dunn, *Oatly learns that it’s not easy being ‘green’*, FORTUNE MAGAZINE (Oct. 11, 2021, 6:30 AM EST), <https://fortune.com/2021/10/11/oatly-oat-milk-green-climate-change-shareholders/>. Oatly also faced backlash for selling an interest to a conglomerate owned by the Chinese government, which has frequently received criticism for human rights abuses and its poor environmental record. See Jess Miller, *Is Oatly Really Eco-Friendly?*, SLATE (July 20, 2021, 5:45 AM), <https://slate.com/business/2021/07/oatly-eco-friendly-oat-milk-investors-controversy.html>.
- <sup>9</sup> Oatly responded to criticism by arguing private equity investments are necessary to increase opportunities for sustainable finance. Press Release, Oatly, *Change Isn’t Easy* (Sept. 2020), <https://www.oatly.com/communication/climate-and-capital>.

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.”<sup>10</sup> 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.

## I. Defense Stocks in the EU Taxonomy

### A. 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 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.<sup>11</sup> It sets up “a classification system, establishing a list of environmentally sustainable economic activities” to facilitate investment in sustainable businesses,<sup>12</sup> 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.”<sup>13</sup> 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

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<sup>10</sup> European Commission Press Release IP/22/2, The Commission, EU Taxonomy: Commission begins expert consultations on Complementary Delegated Act covering certain nuclear and gas activities (Jan. 1, 2022) (available at [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_22\\_2](https://ec.europa.eu/commission/presscorner/detail/en/IP_22_2)).

<sup>11</sup> Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Text with EEA relevance) PE/20/2020/INIT, <http://data.europa.eu/eli/reg/2020/852/oj>.

<sup>12</sup> European Commission, *Why do we need an EU Taxonomy?*, [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en) (last visited Sept. 12, 2021).

<sup>13</sup> *Id.*

renewables.”<sup>14</sup> 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.<sup>15</sup> On the other end of the spectrum are investment firms that take a more flexible approach to permissible ESG-compliant investments.<sup>16</sup>

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.<sup>17</sup> 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.<sup>18</sup> 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.<sup>19</sup> 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

<sup>14</sup> COMMISSION DELEGATED REGULATION (EU) .../.... of 9.3.2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities (Text with EEA relevance), [https://eur-lex.europa.eu/resource.html?uri=cellar:8cee7f13-a162-11ec-83e1-01aa75ed71a1.0023.02/DOC\\_1&format=PDF](https://eur-lex.europa.eu/resource.html?uri=cellar:8cee7f13-a162-11ec-83e1-01aa75ed71a1.0023.02/DOC_1&format=PDF).

<sup>15</sup> Frances Schwartzkopff, *BlackRock Unveils Climate Funds Targeting the Toughest ESG Clients*, BLOOMBERG (Jan. 12, 2022), <https://www.bloomberg.com/news/articles/2022-01-12/blackrock-unveils-new-funds-targeting-toughest-esg-clients?sref=JCixClyW>.

<sup>16</sup> Siri Christiansen, *A third of Europe’s Article 8 and 9 funds have controversial weapons exposure, data suggests*, CITYWIRE SELECTOR (Mar. 21, 2022), <https://citywireselector.com/news/a-third-of-europe-s-article-8-and-9-funds-have-controversial-weapons-exposure-data-suggests/a2382923>.

<sup>17</sup> European Commission, *EU taxonomy: Commission presents Complementary Climate Delegated Act to accelerate decarbonisation*, [https://ec.europa.eu/info/publications/220202-sustainable-finance-taxonomy-complementary-climate-delegated-act\\_en](https://ec.europa.eu/info/publications/220202-sustainable-finance-taxonomy-complementary-climate-delegated-act_en) (last visited Mar. 12, 2022). The Delegated Act supplements the existing EU ESG framework by setting criteria under which certain economic activities—specifically, gas and nuclear energy—can satisfy the objectives of the EU Green Taxonomy.

<sup>18</sup> COMMISSION DELEGATED REGULATION (EU) .../.... of 9.3.2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities (Text with EEA relevance), [https://eur-lex.europa.eu/resource.html?uri=cellar:8cee7f13-a162-11ec-83e1-01aa75ed71a1.0023.02/DOC\\_1&format=PDF](https://eur-lex.europa.eu/resource.html?uri=cellar:8cee7f13-a162-11ec-83e1-01aa75ed71a1.0023.02/DOC_1&format=PDF).

<sup>19</sup> *Id.*

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.<sup>20</sup> 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,<sup>21</sup> and major European defense firms recently issued a joint statement arguing for recognition of the defense industry as a sustainable actor.<sup>22</sup> Second, some commentators have stated that sustainability depends on “the open values of democracy” which require protection afforded by the defense industry.<sup>23</sup>

Despite the conditions imposed on natural gas and nuclear energy activities in order to be considered sustainable,<sup>24</sup> critics have argued that the Delegated Act tarnishes the goals of the EU Green Taxonomy and promotes greenwashing.<sup>25</sup> The inclusion of natural gas was

<sup>20</sup> Diana Dimitrova, et al., *The Growing Climate Stakes for the Defense Industry*, BOSTON CONSULTING GROUP (Sept. 10, 2021), <https://www.bcg.com/publications/2021/growing-climate-stakes-for-the-defense-industry>.

<sup>21</sup> *Id.*

<sup>22</sup> Key ESG-Messages to Governments and the Commission, [https://www.bdsv.eu/files/themen/Nachhaltigkeit/2021-03-26%20Key%20ESG-Messages%20to%20Governments%20and%20the%20Commission.%20final%20\(mit%20Datum\).pdf](https://www.bdsv.eu/files/themen/Nachhaltigkeit/2021-03-26%20Key%20ESG-Messages%20to%20Governments%20and%20the%20Commission.%20final%20(mit%20Datum).pdf) (last visited Mar. 12, 2022); see also Reuters, *Defence Firms Ramp up Pitch to Exit Sustainability Wilderness*, U.S. NEWS (Mar. 11, 2022, 9:49 a.m.), <https://money.usnews.com/investing/news/articles/2022-03-11/defence-firms-ramp-up-pitch-to-exit-sustainability-wilderness>.

<sup>23</sup> Ed Ballard, *Sweden's SEB Changes Course on Defense Stocks as War Tests ESG Rules*, THE WALL STREET JOURNAL (Mar. 2, 2022), <https://www.wsj.com/articles/swedens-seb-changes-course-on-defense-stocks-as-war-tests-esg-rules-11646253384>.

<sup>24</sup> The conditions imposed on these activities are: “for both gas and nuclear, that they contribute to the transition to climate neutrality; for nuclear, that it fulfils nuclear and environmental safety requirements; and for gas, that it contributes to the transition from coal to renewables.” European Commission Press Release IP/22/711, The Commission, EU Taxonomy: Commission presents Complementary Climate Delegated Act to accelerate decarbonisation (Feb. 2, 2022) (available at [https://ec.europa.eu/commission/presscorner/detail/en/ip\\_22\\_711](https://ec.europa.eu/commission/presscorner/detail/en/ip_22_711)).

<sup>25</sup> See, e.g., *EU taxonomy: secret attempt to brand gas and nuclear as 'green'*, WORLD WIDE FUND FOR NATURE (Nov. 1, 2021), <https://www.wwf.eu/?4980841/EU-taxonomy-secret-attempt-to-brand-gas-and-nuclear-as-green>; *Early Analysis of the leaked proposal by Member States on the Taxonomy Delegated Act: focus on gas and nuclear*, WORLD WIDE FUND FOR NATURE European Policy Office (Nov. 2021), [https://wwfeu.awsassets.panda.org/downloads/wwf\\_analysis\\_of\\_member\\_state\\_proposal\\_on\\_gas\\_and\\_nuclear\\_in\\_taxonomy\\_nov21.pdf](https://wwfeu.awsassets.panda.org/downloads/wwf_analysis_of_member_state_proposal_on_gas_and_nuclear_in_taxonomy_nov21.pdf); PRI Position Paper, *Alternative Solutions To Including Gas-Fired Power And Nuclear Energy In The EU Sustainable Taxonomy* (Nov. 19, 2021), <https://www.unpri.org/download?ac=15189>; Stephanie Pfeifer, *IIGCC publishes open letter calling for gas to be excluded from the EU Taxonomy*, THE INSTITUTIONAL INVESTORS GROUP ON CLIMATE CHANGE (Dec. 1, 2022), <https://www.iigcc.org/download/iigcc-publishes-open-letter-calling-for-gas-to-be-excluded-from-the-eu-taxonomy/?wpdmml=5293&refresh=61e1457311b781642153331>; Kate Levick Tsvetelina Kuzmanova and Johannes Schroeten, *Mapping Out A Way Through The Taxonomy Crisis*, E3G (Jan. 2022), <https://9tj4025ol53byww26jdkao0x-wpengine.netdna-ssl.com/wp-content/uploads/EU-Delegated-Act-briefing-paper.pdf>; *Exclusion of natural gas activities from the EU Taxonomy Regulation*, CLIENTEARTH (Oct. 7, 2021), <https://www.clientearth.org/latest/documents/exclusion-of-natural-gas-activities-from-the-eu-taxonomy-regulation/>; Silvia Amaro, *EU's plan to include gas and nuclear in 'green' ranking leaves investors confused*, CNBC (Jan. 6, 2022, 2:11 AM EST), <https://www.cnbc.com/2022/01/06/eus-plan-to-include-gas-nuclear-in-green-ranking-leaves-investors-confused.html>; Kate Abnett and Simon Jessop, *EU lawmakers move to reject green gas and nuclear*



particularly contentious because continued natural gas production and use is contrary to the International Energy Agency's Net Zero recommendations,<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup> While the Delegated Act was under review, the EU's Platform on Sustainable Finance (the "SF Platform")<sup>29</sup> suggested the Delegated Act would pose "a serious risk of undermining the sustainable Taxonomy framework."<sup>30</sup> 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."<sup>31</sup> The SF Platform also identified many

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investment rules, REUTERS (Mar. 30, 2022, 1:25 PM EDT), <https://www.reuters.com/business/sustainable-business/eu-lawmakers-move-reject-green-gas-nuclear-investment-rules-2022-03-30/>.

<sup>26</sup>The International Energy Agency is a coalition that was founded in 1974 by a host of member countries in order to foster global dialogue on energy. See International Energy Agency, *Mission*, <https://www.iea.org/about/mission> (last visited Apr. 1, 2022). As the EU is one of its members, it conducts regular reviews of EU energy policies. See, e.g., International Energy Agency, *European Union 2020 Energy Policy Review* (June 25, 2020), <https://www.iea.org/reports/european-union-2020>.

<sup>27</sup>International Energy Agency, *Net Zero by 2050 Report*, <https://www.iea.org/reports/net-zero-by-2050> (last visited Mar. 17, 2022).

<sup>28</sup>Working Group on Energy and Climate Change, *'Do no significant harm' Technical Guidance by the Commission* (Feb. 16, 2021), [https://ec.europa.eu/info/sites/default/files/2021\\_02\\_18\\_epc\\_do\\_not\\_significant\\_harm\\_-\\_technical\\_guidance\\_by\\_the\\_commission.pdf](https://ec.europa.eu/info/sites/default/files/2021_02_18_epc_do_not_significant_harm_-_technical_guidance_by_the_commission.pdf). DNSH principles require that any measure taken to accomplish one of the EU Green Taxonomy's environmental objectives not lead to significant harm of any of the other environmental objectives. *Id.* These principles apply to both governmental reforms and private investment and require a DNSH assessment for every measure taken. *Id.*; see also Commission Notice, *Technical guidance on the application of "do no significant harm" under the Recovery and Resilience Facility Regulation*, [https://ec.europa.eu/info/sites/default/files/c2021\\_1054\\_en.pdf](https://ec.europa.eu/info/sites/default/files/c2021_1054_en.pdf). As explained below, other jurisdictions that have adopted sustainability guidelines have incorporated similar DNSH principles aligning with their sustainability objectives.

<sup>29</sup>The SF Platform is a permanent expert group established by the EU Green Taxonomy that assists the EU in developing its sustainable finance policies. See Platform on Sustainable Finance, *What the Platform does*, [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance\\_en#what](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en#what) (last visited Apr. 1, 2022).

<sup>30</sup>Platform on Sustainable Finance, *Response to the Complementary Delegated Act* (Jan. 21, 2022), [https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/220121-sustainable-finance-platform-response-taxonomy-complementary-delegated-act\\_en.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/220121-sustainable-finance-platform-response-taxonomy-complementary-delegated-act_en.pdf).

<sup>31</sup>*Id.* at 5.

inconsistencies between the Delegated Act and the principles and objectives of the EU Green Taxonomy.<sup>32</sup>

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.<sup>33</sup> EU member nations such as Germany, Austria, Luxembourg and Spain have all suggested legal action against the Delegated Act.<sup>34</sup> Germany is considering a legal challenge based on the legal form of the Delegated Act.<sup>35</sup> 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.<sup>36</sup> 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.<sup>37</sup>

## B. The EU Social Taxonomy

The Platform published its final report on the proposed EU Social Taxonomy on February 28, 2022.<sup>38</sup> 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.<sup>39</sup> Unlike the EU Green Taxonomy's six defined environmental objectives,<sup>40</sup> the

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<sup>32</sup> See generally *id.* at 13–40.

<sup>33</sup> Press Release, ClientEarth, Environmental lawyers take first step to challenge EU taxonomy in Court (Feb. 4, 2022), <https://www.clientearth.org/latest/press-office/press/environmental-lawyers-take-first-step-to-challenge-eu-taxonomy-in-court/>.

<sup>34</sup> Nikolaus J. Kurmayer, *Germany considering lawsuit against EU taxonomy*, EURACTIV.COM (Feb. 8, 2022), <https://www.euractiv.com/section/energy/news/germany-considering-lawsuit-against-eu-taxonomy/>.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*; see also Mehreen Khan and Daniel Dombey, *Brussels faces threat of legal challenge over sustainable finance rules*, FINANCIAL TIMES (Jan. 23, 2022), <https://www.ft.com/content/48d44c9a-298e-4203-a160-772a032d1c36>.

<sup>37</sup> Frédéric Simon and Kira Taylor, *Lawmakers urge Brussels to ditch green label for gas in EU taxonomy*, EURACTIV (Mar. 17, 2022), <https://www.euractiv.com/section/energy-environment/news/lawmakers-urge-brussels-to-ditch-green-label-for-gas-in-eu-taxonomy/>.

<sup>38</sup> Platform on Sustainable Finance, *Final Report on Social Taxonomy* (Feb. 2022), [https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/280222-sustainable-finance-platform-finance-report-social-taxonomy.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/280222-sustainable-finance-platform-finance-report-social-taxonomy.pdf) [hereinafter “Social Taxonomy Final Report”].

<sup>39</sup> *Id.* at 8.

<sup>40</sup> The EU Taxonomy lists six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, or the protection and restoration of biodiversity and ecosystems. Technical Expert Group on Sustainable

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.<sup>41</sup> 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.”<sup>42</sup> The goal of the guidelines would be to prevent “social washing”—a danger comparable to greenwashing.<sup>43</sup> Social washing refers to misrepresentations made by a company that make the company appear more socially responsible than it is.<sup>44</sup> 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.<sup>45</sup>

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).<sup>46</sup> This is a change from a draft report in February, which identified all weapons as

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Finance, Spotlight on Taxonomy,

[https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/sustainable-finance-taxonomy-spotlight\\_en.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-spotlight_en.pdf).

<sup>41</sup> Social Taxonomy Final Report at 7–8.

<sup>42</sup> *Id.* at 8.

<sup>43</sup> *Id.* at 77.

<sup>44</sup> Alastair Marsh, ‘Social Washing’ Is Becoming Growing Headache for ESG Investors, BLOOMBERG (Apr. 9, 2020), <https://www.bloomberg.com/news/articles/2020-04-09/-social-washing-is-becoming-growing-headache-for-esg-investors>.

<sup>45</sup> Social Taxonomy Final Report at 77–78.

<sup>46</sup> *Id.* at 70–71. Defense technology like surveillance tools or intelligence protocols that are governed by similar international treaties, conventions, and protocols could also be considered socially harmful, but are not specifically addressed in the Social Taxonomy Final Report.



significantly harmful and ideal for exclusion from social investments.<sup>47</sup> 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.<sup>48</sup> Others speculate that the reference was omitted due to defense lobbying.<sup>49</sup> Despite the change, however, the rapporteur maintains that weapons could not qualify as social goods because they do not promote human rights.<sup>50</sup> 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.<sup>51</sup>

## II. 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.

**A. 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.<sup>52</sup> 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.<sup>53</sup> All green bond issuers that

<sup>47</sup> Platform on Sustainable Finance, *Draft Report by Subgroup 4: Social Taxonomy* 33 (July 2021), [https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/sf-draft-report-social-taxonomy-july2021\\_en.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sf-draft-report-social-taxonomy-july2021_en.pdf).

<sup>48</sup> Gina Gambetta, *Armaments ‘cannot be classified as social’ in taxonomy, says rapporteur*, RESPONSIBLE INVESTOR (Mar. 1, 2022), <https://www.responsible-investor.com/armaments-cannot-be-classified-as-social-in-taxonomy-says-rapporteur/>.

<sup>49</sup> Reuters, *Defence Firms Ramp up Pitch to Exit Sustainability Wilderness*, U.S. NEWS (Mar. 11, 2022, 9:49 a.m.), <https://money.usnews.com/investing/news/articles/2022-03-11/defence-firms-ramp-up-pitch-to-exit-sustainability-wilderness>.

<sup>50</sup> *Id.*

<sup>51</sup> Peggy Hollinger, *EU risks its own security by branding defence industry socially harmful*, FINANCIAL TIMES (Dec. 1, 2021), <https://www.ft.com/content/31933a53-c5ad-4633-826c-adc945f62207>.

<sup>52</sup> Notice on Issuing the Green Bond Endorsed Projects Catalogue (2021 Edition) (No. 96 [2021], PBOC, NDRC, CSRC), <https://www.climatebonds.net/files/files/the-Green-Bond-Endorsed-Project-Catalogue-2021-Edition-110521.pdf>.

<sup>53</sup> Similar to China, Russia follows a whitelist approach and private financial instruments issued to Russian and international investors must undergo a mandatory verification in order to obtain green certification. See International Platform on Sustainable Finance, *Common Ground Taxonomy – Climate Change Mitigation* 36, [https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/211104-ipsf-common-ground-taxonomy-instruction-report-2021\\_en.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/211104-ipsf-common-ground-taxonomy-instruction-report-2021_en.pdf). Adopted in October 2021, the Russian Green Taxonomy aims for carbon neutrality of its economy by 2060. AFP, *Russia Aiming for Carbon Neutrality by 2060*,

solicit investors both in China and internationally must adhere to China's taxonomy.<sup>54</sup> 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."<sup>55</sup> 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.<sup>56</sup> China and the EU published a joint analysis of both the Catalogue and the EU Green Taxonomy, the Common Ground Taxonomy.<sup>57</sup> While not a legally binding document, it does indicate that China will cooperate with the EU on sustainable finance issues.

**B. 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.<sup>58</sup> The K-Taxonomy includes liquefied natural gas—at much higher levels than the Delegated Act—but omits nuclear energy.<sup>59</sup> 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"

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*Putin Says*, THE MOSCOW TIMES (Oct. 13, 2021), <https://www.themoscowtimes.com/2021/10/13/russia-aiming-for-carbon-neutrality-by-2060-putin-says-a75284>. The Russian Green Taxonomy does include nuclear energy and transition pathways to climate-neutrality, but does not incorporate DNSH criteria. Press Release, Climate Bonds Initiative, Russian Federation adopts green taxonomy: Matches 100g CO2 gas-power threshold in EU Parliament's approved Act (Oct. 11, 2021), <https://www.climatebonds.net/resources/press-releases/2021/11/russian-federation-adopts-green-taxonomy-matches-100g-co2-gas-power>. This article does not address the Russian Green Taxonomy in depth due to the current political climate.

<sup>54</sup> As of 2020, China's green bond issuances had a total value of approximately \$44 billion USD in domestic and overseas markets. Taotao Yue, *China's Burgeoning Green Bond Market: Developments, Characteristics, and Outlook*, SUSTAINANALYTICS (Feb. 28, 2022), <https://www.sustainalytics.com/esg-research/resource/corporate-esg-blog/china-burgeoning-green-bond-market-developments-characteristics-outlook>; see also Jian Chen and Joy Zhang, *China's Green-Bond Market: Growing Issuance and Historical Outperformance*, MSCI (Feb. 24, 2022), <https://www.msci.com/www/blog-posts/china-s-green-bond-market/03029315810>.

<sup>55</sup> *Id.* at 1.

<sup>56</sup> SynTao Green Finance, Highlights of China's New Green Catalogue 2021 (Apr. 23, 2021), <http://www.syntaogf.com/Uploads/files/Highlights%20of%20China%E2%80%99s%20New%20Green%20Catalogue%202021.pdf>.

<sup>57</sup> International Platform on Sustainable Finance, *Common Ground Taxonomy – Climate Change Mitigation*, [https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/211104-ipsf-common-ground-taxonomy-instruction-report-2021\\_en.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/211104-ipsf-common-ground-taxonomy-instruction-report-2021_en.pdf).

<sup>58</sup> Soo Young Song, et al., *The Korean Green Taxonomy (K-Taxonomy) Guideline and Its Implications*, SHIN & KIM LLC (Jan. 25, 2022), <https://www.shinkim.com/eng/media/newsletter/1690?page=0&code=&keyword>.

<sup>59</sup> Viktor Tachev, *South Korean Green Taxonomy Declared "Gas is Green"*, ENERGY TRACKER ASIA (Jan. 14, 2022), <https://energytracker.asia/south-korean-green-taxonomy-declared-gas-is-green/>.

to climate objectives, DNSH, and minimum safeguards.<sup>60</sup> Therefore, any policies adopted in the future by the EU may also come to be incorporated into the K-Taxonomy.<sup>61</sup>

**C. South Africa:** The Green Finance Taxonomy is aimed at revitalizing South Africa's economy and achieving low carbon goals.<sup>62</sup> 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."<sup>63</sup> South Africa's standards are heavily influenced by international trends and there are plans to expand to a social taxonomy.<sup>64</sup> Any major future policies adopted by jurisdictions like the EU, China and the U.S. could be incorporated by South Africa as well.

**D. 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.<sup>65</sup> 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;<sup>66</sup> scope 3 greenhouse gas emissions metrics, if

<sup>60</sup> International Platform on Sustainable Finance, *Common Ground Taxonomy – Climate Change Mitigation* 37, [https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/211104-ipsf-common-ground-taxonomy-instruction-report-2021\\_en.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/211104-ipsf-common-ground-taxonomy-instruction-report-2021_en.pdf).

<sup>61</sup> Sonal Patel, *Nuclear and Natural Gas Taxonomy Battles Brewing in Europe and S. Korea*, POWER MAGAZINE (Dec. 1, 2020), <https://www.powermag.com/nuclear-and-natural-gas-taxonomy-battles-brewing-in-europe-and-s-korea/>.

<sup>62</sup> Republic of South Africa Nat'l Treasury, Draft Technical Paper, Financing a Sustainable Economy (2020), <http://www.treasury.gov.za/publications/other/Sustainability%20technical%20paper%202020.pdf>.

<sup>63</sup> Republic of South Africa Nat'l Treasury, South African Green Finance Taxonomy 1st Edition (Apr. 1, 2022), <https://sustainablefinanceinitiative.org.za/wp-content/downloads/SA-Green-Finance-Taxonomy-1st-Edition-Final-01-04-2022.pdf>.

<sup>64</sup> Sophie Robinson-Tillett, 'We will start with green but the hope is that we'll be able to integrate the broader goals of the SDGs as time goes on': South Africa's taxonomy, RESPONSIBLE INVESTOR (Sept. 16, 2020), <https://www.responsible-investor.com/we-will-start-with-green-but-the-hope-is-that-we-ll-be-able-to-integrate-the-broader-goals-of-the-sdgs-as-time-goes-on-south-africa-s-taxonomy/>.

<sup>65</sup> The Enhancement and Standardization of Climate-Related Disclosures for Investors, Exchange Act Release Nos. 33-11042; 34-94478; File No. S7-10-22, Fed.Sec.L.Rep. (proposed Mar. 21, 2022).

<sup>66</sup> "Scope 1 emissions" would be defined as direct GHG emissions from operations that are owned or controlled by a registrant. "Scope 2 emissions" would be defined as indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat, or cooling that is consumed by operations owned or controlled by a registrant. *Id.* at 480.

material, or if the registrant has set a greenhouse gas emissions reduction target or goal that includes its Scope 3 emissions;<sup>67</sup> and the registrant's climate-related targets or goals, and transition plan, if the registrant has one.<sup>68</sup> 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.

### III. Takeaways

- A. 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.<sup>69</sup> 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

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<sup>67</sup> “Scope 3 emissions” would be defined as all indirect GHG emissions not otherwise included in a registrant's Scope 2 emissions, which occur in the upstream and downstream activities of a registrant's value chain. Upstream activities in which Scope 3 emissions might occur include: (i) a registrant's purchased goods and services; (ii) a registrant's capital goods; (iii) a registrant's fuel and energy related activities not included in Scope 1 or Scope 2 emissions; (iv) transportation and distribution of purchased goods, raw materials, and other inputs; (v) waste generated in a registrant's operations; (vi) business travel by a registrant's employees; (vii) employee commuting by a registrant's employees; and (viii) a registrant's leased assets related principally to purchased or acquired goods or services. Downstream activities in which Scope 3 emissions might occur include: (i) transportation and distribution of a registrant's sold products, goods or other outputs; (ii) processing by a third party of a registrant's sold products; (iii) use by a third party of a registrant's sold products; (iv) end-of-life treatment by a third party of a registrant's sold products; (v) a registrant's leased assets related principally to the sale or disposition of goods or services; (vi) a registrant's franchises; and (vii) investments by a registrant. *Id.*

<sup>68</sup> For additional insight, see Jason Halper et al., SEC Proposes Climate-Related Changes to Regulation S-K and Regulation S-X, Cadwalader, Wickersham & Taft LLP (Mar. 23, 2022), <https://www.cadwalader.com/resources/clients-friends-memos/sec-proposes-climate-related-changes-to-regulation-s-k-and-regulation-s-x>.

<sup>69</sup> Steven Arons and John Ainger, *Banks Change Course on Weapons Finance as Defense Spending Soars*, BLOOMBERG (Mar. 4, 2022, 4:43 AM EST), <https://www.bloomberg.com/news/articles/2022-03-03/banks-change-tack-on-weapons-finance-as-defense-spending-soars>.

investment portfolios.<sup>70</sup> One advocacy group has set up a website specifically to help investors demilitarize their portfolios.<sup>71</sup>

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.<sup>72</sup> Defense companies have been attempting to go green for some time, starting with internal operations and energy usage.<sup>73</sup> As regulators around the globe continue to work to promulgate ESG standards, the defense industry has been advocating for recognition as a sustainable actor.<sup>74</sup>

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.

**B. 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

<sup>70</sup> EUROPEAN SRI STUDY 2018, Eurosif, <https://www.eurosif.org/wp-content/uploads/2021/10/European-SRI-2018-Study.pdf>.

<sup>71</sup> Weapon Free Funds, <https://weaponfreefunds.org/> (last visited May 8, 2022).

<sup>72</sup> Larissa Fernand, *Should ESG investors invest in defense stocks?*, MORNINGSTAR (Nov. 11, 2020), <https://www.morningstar.in/posts/60819/esg-investors-invest-defense-stocks.aspx> (discussing the exclusionary and integration approaches to sustainable finance investing).

<sup>73</sup> Diana Dimitrova, et al., *The Growing Climate Stakes for the Defense Industry*, BOSTON CONSULTING GROUP (Sept. 10, 2021), <https://www.bcg.com/publications/2021/growing-climate-stakes-for-the-defense-industry>.

<sup>74</sup> Key ESG-Messages to Governments and the Commission, [https://www.bdsv.eu/files/themen/Nachhaltigkeit/2021-03-26%20Key%20ESG-Messages%20to%20Governments%20and%20the%20Commission.%20final%20\(mit%20Datum\).pdf](https://www.bdsv.eu/files/themen/Nachhaltigkeit/2021-03-26%20Key%20ESG-Messages%20to%20Governments%20and%20the%20Commission.%20final%20(mit%20Datum).pdf) (last visited Mar. 12, 2022); see also Reuters, *Defence Firms Ramp up Pitch to Exit Sustainability Wilderness*, U.S. NEWS (Mar. 11, 2022, 9:49 a.m.), <https://money.usnews.com/investing/news/articles/2022-03-11/defence-firms-ramp-up-pitch-to-exit-sustainability-wilderness>.

defense industry.<sup>75</sup> 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.”<sup>76</sup> 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.<sup>77</sup> In the U.S., polls indicate that the majority of Americans currently view defense spending as a social good.<sup>78</sup> 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.<sup>79</sup>

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.<sup>80</sup> 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

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<sup>75</sup> Ed Ballard, *Sweden’s SEB Changes Course on Defense Stocks as War Tests ESG Rules*, THE WALL STREET JOURNAL (Mar. 2, 2022, 3:36 pm ET), <https://www.wsj.com/articles/swedens-seb-changes-course-on-defense-stocks-as-war-tests-esg-rules-11646253384>.

<sup>76</sup> Steven Arons and John Ainger, *Banks Change Course on Weapons Finance as Defense Spending Soars*, BLOOMBERG (Mar. 4, 2022, 4:43 AM EST), <https://www.bloomberg.com/news/articles/2022-03-03/banks-change-tack-on-weapons-finance-as-defense-spending-soars>.

<sup>77</sup> John Ainger and Steven Arons, *Weapons Group Points to Ukraine in Bid to Shape ESG Rulebook*, BLOOMBERGQUINT (Feb. 28, 2022, 5:13 AM IST), <https://www.bloombergquint.com/politics/weapons-group-points-to-ukraine-in-bid-to-shape-eu-s-esg-rules/>; Birgit Jennen, Alexander Michael Pearson, and Arne Delfs, *Germany to Boost Military Spending in Latest Historic Shift*, Bloomberg (Feb. 27, 2022, 10:24 AM EST), <https://www.bloomberg.com/news/articles/2022-02-27/-putin-s-war-prompts-radical-rethink-for-scholz-and-germany>.

<sup>78</sup> Frank Newport, *Defense Investing in the Context of U.S. Public Opinion*, GALLUP (Mar. 11, 2022), <https://news.gallup.com/opinion/polling-matters/390644/defense-investing-context-public-opinion.aspx>.

<sup>79</sup> Sergei Klebnikov, *War Stocks Are Surging As Russia-Ukraine Conflict Rages On: Lockheed Martin, Northrop Up 20%*, FORBES (Mar. 4, 2022, 2:36 pm EST), <https://www.forbes.com/sites/sergeiklebnikov/2022/03/04/war-stocks-are-surging-as-russia-ukraine-conflict-rages-on-lockheed-martin-northrop-up-20/?sh=176a1de443f0>; 7 years of uninterrupted growth takes global defence spend to USD1.9 trillion, says Janes, JANES (Jan. 26, 2021), <https://www.janes.com/defence-news/news-detail/7-years-of-uninterrupted-growth-takes-global-defence-spend-to-usd1.9-trillion-says-janes> (defense spending had already increased prior to Russia’s invasion of Ukraine).

<sup>80</sup> Holly Pettingale, Stéphane de Maupéou, and Peter Reilly, *EU Taxonomy and the Future of Reporting*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Apr. 4, 2022), <https://corpgov.law.harvard.edu/2022/04/04/eu-taxonomy-and-the-future-of-reporting/>.



or frowns upon transitional activities, whether the jurisdiction's taxonomy use flexible or whitelist structure, and whether the country has adopted the DNSH approach.

- C. 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.<sup>81</sup> 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.”<sup>82</sup> 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—e.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.”<sup>83</sup> 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.
- D. 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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<sup>81</sup> European Commission Press Release QANDA/22/712, The Commission, Questions and Answers on the EU Taxonomy Complementary Climate Delegated Act covering certain nuclear and gas activities (Feb. 2, 2022) (available at [https://ec.europa.eu/commission/presscorner/detail/en/qanda\\_22\\_712](https://ec.europa.eu/commission/presscorner/detail/en/qanda_22_712)).

<sup>82</sup> *Id.*

<sup>83</sup> Merryn Somerset Webb, *Are defence stocks now ESG?*, FINANCIAL TIMES (Mar. 4, 2022), <https://www.ft.com/content/9073a69f-bc90-4944-b9d9-d2a0a2ff1f15>.

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

|                       |                 |                                                                                  |
|-----------------------|-----------------|----------------------------------------------------------------------------------|
| Jason Halper          | +1 212 504 6300 | <a href="mailto:jason.halper@cwt.com">jason.halper@cwt.com</a>                   |
| Ellen Holloman        | +1 212 504 6200 | <a href="mailto:ellen.holloman@cwt.com">ellen.holloman@cwt.com</a>               |
| Sara Bussiere         | +1 212 504 6255 | <a href="mailto:sara.bussiere@cwt.com">sara.bussiere@cwt.com</a>                 |
| Timbre Shriver        | +1 212 504 6377 | <a href="mailto:timbre.shriver@cwt.com">timbre.shriver@cwt.com</a>               |
| Jayshree Balakrishnan | +1 212 504 6402 | <a href="mailto:jayshree.balakrishnan@cwt.com">jayshree.balakrishnan@cwt.com</a> |