Investment in Defence and the EU Defence Readiness Omnibus

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Governments worldwide are increasing their national defence spending and looking for new ways to encourage investment in defence industries, including through private capital. The EU has published its position on the importance of defence investment, sovereignty and immediate and future challenges, not least those arising from Russia's aggressive war against Ukraine. In March 2025, the European Commission launched a plan to raise over €800 billion in defence spending, including through mobilising private capital. Following this, the European Commission recently published the Defence Readiness Omnibus, a set of proposals to facilitate investment in the EU defence sector, including to streamline defence procurement procedures by Member States and to simplify applications to the European Defence Fund, which offers grants for defence projects. For investors and asset managers, the package includes guidance and a legislative proposal to align the EU's position on defence with its sustainable finance framework, with the intention to increase investment in EU listed and unlisted defence companies.

In the United Kingdom, the FCA published its position in March 2025 on sustainability regulations and UK defence, stating that "the financial sector plays a vital role in supporting all sectors, including defence. There is nothing in our rules, including those related to sustainability, that prevents investment or finance for defence companies". Industry bodies representing UK financial services and the defence sector also published a joint position paper in May of this year, which highlights the challenges that UK defence companies have faced in obtaining financing, and identifies one solution as including "regulatory measures in connection with ESG ratings and fund labelling".

On a similar note, the European Investment Bank ("EIB") has historically excluded all types of ammunition, weapons, and military equipment and infrastructure, from its financing activities, reflecting its founding principles of peace, security and human rights. In 2024, it dropped its requirement for "dual-use" projects to be eligible for funding, to derive more than 50% of their revenue from civilian use. It further recently announced its support for the EU's declarations on the importance of the defence sector and that it is "re-evaluating the list of excluded activities [that it is willing to finance]",

although this is expected only to encompass "non-lethal" activities in the defence sector, such as surveillance, communications and cybersecurity.

In this Debevoise In Depth, we consider how asset managers have to date approached investment in the defence sector, and the impact of the guidance and legislative proposals in the EU's Defence Readiness Omnibus on private capital.

Overview of the EU Defence Sector

Chief in the defence sector are defence prime contractors, which are companies that are primarily responsible for delivering major defence-related projects or systems, including military aircraft, space vehicles, missile systems, ammunition, small arms, naval ships and other commercial and military vehicles. The defence sector includes space as well as aerospace systems, cyber defence tools and training and logistical support. Some technologies, such as drones, are dual-use, which may require scrutiny as to their predominant use. Revenue in the sector is driven by government procurement contracts. The EU has a "Common Position" on the export of military technology and equipment, with criteria, such as the respect of human rights in the recipient country, which Member State authorities must consider when granting an export licence. The Arms Trade Treaty and Treaty on Non-Proliferation of Nuclear Weapons, adhered to by all EU Member States, cover the transfer of conventional and nuclear weapons. The separate Treaty on Prohibition of Nuclear Weapons has been adhered to by only three EU Member States. Intra-EU exports are also regulated by an EU Directive. Lastly, state foreign defence investment regimes will generally limit investment by foreign investors in national defence and security industries. It is interesting to note that, in the U.S. and the EU, defence development and procurement is undertaken primarily through large publicly listed defence companies, and not by state-owned entities, compared to other large economies.

Fitting Investment in the Defence Sector into the EU SFDR

The Sustainable Finance Disclosure Regulation ("SFDR") introduced the categories of Article 8, for funds that promote a range of environmental or social characteristics, and Article 9, for funds that make "sustainable investments", which are investments that contribute to specific environmental or social outcomes.

The Defence Readiness Omnibus includes guidance and legislative proposals to prevent investors from "unduly discriminating" against the defence sector in investment decisions. In its Notice, the Commission states that, under the EU SFDR, "the defence

industry is treated like any other sector, and only "controversial weapons" are deemed subject to additional disclosure requirements". On this basis, an asset manager could form a fund that in part or substantially invests in the defence sector and select one or more environmental or social themes to promote, such as low carbon-emitting manufacturing or treatment of the workforce, or even supply chain due diligence, throughout those investments. In this regard, the Sustainability Accounting Standards Board ("SASB") defines sustainability risks and opportunities for each industry sector, with its guidance for the Aerospace and Defence Industry listing the following as material topics: energy management (energy consumed in manufacturing, and the proportion from renewable sources); hazardous waste management; data security; product safety (for instance, product recalls); fuel economy; materials sourcing (management of risks associated with the use of critical materials) and business ethics (involvement in corruption or bribery, or revenue from countries with poor anti-corruption rankings). The IFRS has published similar guidance on implementing climate-related disclosures for industries, including on aerospace and defence. Notably, neither of these frameworks refer to greenhouse gas emissions generated through the use of defence aircraft, ships or vehicles, other than a reference as to whether the company has a strategy to address fuel economy and reduce greenhouse gas emissions in the use of its products.

Additionally, in the Defence Readiness Omnibus, in the Commission's view, investors may conclude, on a case-by-case basis, that "activities conducted by the EU defence industry to safeguard peace and security, provided they do not significantly harm any other sustainability objectives and that the company conducting the activity follows good governance practices, contribute to social objectives".

Here, the Commission is pointing to the possibility of asset managers classifying investments in the defence sector as "sustainable investments" under the SFDR for Article 8 and Article 9 funds, which would require the manager to define specific and measurable social benefits of the investment and demonstrate that such investments pass the test of doing "no significant harm" to any other social or environmental objective.

Under the SFDR, principal adverse impact ("PAI") indicators 10 and 11 refer to violations of, and lack of processes and compliance mechanisms to monitor compliance with, the UN Global Compact principles and OECD Guidelines for Multinational Enterprises. Investors in scope of the SFDR will have regard to PAIs 10 and 11 in a number of contexts, including in the "do no significant harm" check to qualify an investment as a "sustainable investment". In the context of investing in the defence sector, to ensure compliance with PAI indicators 10 and 11, the Commission states that investors should check compliance by investee companies with the export control legislation summarised above. This will likely require careful due diligence as to the

processes that the investee company has in place, and investigations into any prior breaches.

Other Points Raised by the Defence Readiness Omnibus

In its Notice, the Commission makes the following other points:

- Companies in the defence sector can claim alignment with the EU Taxonomy Regulation (its classification system for environmentally sustainable activities) for "eligible horizontal activities". This means that, whilst the defence sector is not covered by the Taxonomy by reference to, for instance, arms manufacturing activity, capital expenditure by a company in this sector such as to reduce its emissions in its buildings, or in electric vehicles, is in scope of the Taxonomy.

- The Corporate Sustainability Due Diligence Directive ("CSDDD") applies to defence companies which are large enough to be in scope, and the Commission notes that CSDDD excludes defence companies from conducting due diligence (checks on adverse social and environmental impacts) on their "downstream" business partners (broadly, customers) where the export of military products to the customer is authorised by Member State authorities.

The Commission also notes that it may change the European Sustainability Reporting Standards that accompany the Corporate Sustainability Reporting Directive, to further allow defence companies to withhold sensitive information from their public sustainability reporting, for example, the volume of raw materials they purchase.

The EU's Approach to Defining Controversial Weapons

The European Commission, in developing the SFDR, included companies involved in the manufacture or selling of controversial weapons as PAI indicator 14, with controversial weapons defined as "anti-personnel mines, cluster munitions, chemical and biological weapons". These are the key types of weapons which are banned, or their use heavily restricted, by those countries which have signed the relevant international treaties. Controversial weapons are classified as such because of their indiscriminate and long-lasting impacts on environments and communities. Other types of weapons, such as those that use depleted uranium and white phosphorus, are considered controversial but not subject to comprehensive bans in international treaties.

In the EU's separate Benchmarks Regulation, which defines minimum standards for climate benchmarks, companies involved in any activities related to controversial weapons are excluded from these benchmarks, with controversial weapons defined as controversial weapons as referred to in international treaties and conventions, United Nations principles and, where applicable, national legislation.

Noting that there is some confusion about the scope of both definitions, and that the two definitions are not aligned, the Commission's Notice in its Defence Readiness Omnibus confirms the following:

- That the PAI covering controversial weapons refers to each type of weapon as prohibited by each relevant Convention.

- That the Commission proposes to change the Benchmarks Regulation to replace the broad reference to controversial weapons in the exclusions criteria for the Paris-Aligned and Climate Transition Benchmarks with a reference to the four types of controversial weapons listed above, as prohibited by each relevant Convention.

The Commission's changes are intended to limit the breadth of the definition in the Benchmarks Regulation to those weapons prohibited by the international arms conventions to which the majority of Member States are party. Under ESMA's Guidelines, funds that use ESG terms in their names must adhere to the exclusion criteria set out in the Benchmark Regulation's Paris-Aligned and Climate Transition Benchmarks.[1]

In this context, it is worth noting that neither the U.S. nor China have signed the Ottawa Treaty on the use of land mines, and that several EU Member States have recently announced their intention to withdraw from the Ottawa Treaty. Also, sponsors with their own exclusions, which refer to controversial weapons, may now wish to consider alignment with the EU definition.

Approaches by Asset Managers to the Defence Sector in Their Exclusion Criteria

Many asset managers have prohibited investment in companies involved in weapons, or in controversial weapons, in their exclusion criteria, and have accepted similar restrictions from investors. Asset managers have taken different approaches:

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[1] The change to the Benchmarks Regulation confirms the position in ESMA's December 2024 Q&A, which clarifies that controversial weapons under the Guidelines are limited to the types of controversial weapons prohibited by each Convention.

- The majority have excluded investment in companies involved in weapons that are banned under international treaties or otherwise treated as "controversial". For this purpose, managers often refer to the MSCI Global ex Controversial Weapons Indexes Methodology. Asset managers which adopt the MSCI Methodology will generally exclude producers of essential components involved in the controversial weapons listed. In addition, almost all managers which have not formally excluded controversial weapons have in practice been unlikely to invest in them.

- Some asset managers have adopted a broader exclusion, in particular for funds which they have categorised as promoting environmental or social characteristics, from investing in the defence sector and from investing in companies that generate more than a small threshold of revenue from the defence sector. This is an approach that at least one manager has recently changed, announcing that it would no longer apply an exclusion for companies that generate more than 10% of their revenue from military equipment and service to its funds in the SFDR Article 8 category.

- Some asset managers restrict investment in companies involved in weapons for recreational use, but not the larger defence sector. Also, it is open to asset managers to distinguish investments in companies that produce purely defensive weapons (such as air defence systems) and other weapons, similar to the EIB's intended approach, summarised above.

- Any manager, in adopting any exclusion from investing in the defence sector, needs to consider its application both to defence "prime contractors" and the large number of companies in the defence industry supply chain, supplying, for instance, components and software to that industry.

- Asset managers should also be mindful that certain U.S. states have implemented laws targeting asset managers that "boycott" weapons and firearms industries, and should seek advice on any conflict with its exclusions list before engaging with these U.S. state investors.

In light of managers' approaches to exclusions to date, note the Commission's view in the Defence Readiness Omnibus that "generalised exclusions of the defence sector based on turnover are not consistent with a case-by-case logic to mitigate risks related to sustainability considerations…[and are] inconsistent with the EU's strategic needs and priorities, as the use of revenue thresholds to exclude the defence sector would particularly penalise SMEs, which…often cannot diversify their activities into civilian markets".

In light of the EU's proposal, investors and managers may want to review their exclusion policies to increase flexibility to invest in defence and to address any

ambiguities in their policies. Asset managers investing in the defence sector, including in any company producing components, will need to conduct careful due diligence to ensure that their investments comply with regulatory restrictions, including on controversial weapons and dual-use goods and export control restrictions. We will continue to monitor the legislative process.

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Please do not hesitate to contact us with any questions.

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