

NAVIGATING DEFENCE AND RESPONSIBLE INVESTMENT – 8 KEY POINTS

1. Historically, investment in defence has been considered out of bounds for PE and VC funds due to LP sensitivity around investments in the defence sector and a perceived tension with responsible investment principles and sustainability-related regulatory restrictions and exclusions. In particular, there has been concern about defence investment compatibility with the **Sustainable Finance Disclosure Regulation** (SFDR), LPs' own investment restrictions and about limited transparency around the practical application of dual-use technology, the end-users of military hardware and the sector's heightened exposure to global bribery and corruption risks. A number of these concerns remain, but others have been / are being specifically addressed as part of international efforts to boost private investment in the sector.

2. Global geopolitical tensions have driven strategic government priorities focused on national security. For example, in June 2025, NATO Allies **agreed** to increase annual defence spending to 5% of GDP by 2035. The UK also recently published its **Strategic Defence Review**, updated in July 2025, which includes an annual budget of GBP 11 billion to invest in national defence and a target to spend 2.5% GDP on defence by 2027. Meanwhile, the EU has launched the **Defence Readiness 2030** initiative aiming to mobilise EUR 800 billion to strengthen European defence capabilities. This drive by governments has prompted a broader reassessment of defence investments as potentially compatible with sustainable objectives, subject to certain safeguards.

3. Certain financial regulators seeking to allay private market concerns have issued public statements confirming that their rules do not prohibit defence investment. For example, in March 2025, the UK Financial Conduct Authority released a **specific webpage** to confirm "there is nothing in [its] rules, including those related to sustainability, that prevents investment or finance for defence companies". In May 2025 and in response to government and investment interest in the sector, the German Federal Financial

Supervisory Authority (BaFin) released **guidance** urging asset managers to be transparent about increasing their defence sector holdings, especially in funds marketed as sustainable; and the French Autorité des Marchés Financiers (AMF) released a **statement** which included emphasising support for the European Commission (EC) position that the EU sustainable finance framework does not prevent the financing of the European defence sector.

4. A draft SFDR-focused Notice which accompanied the EU Defence Readiness Omnibus, published by the European Commission in June 2025, clarified that defence investments might be compatible with funds designated as Article 8 or 9 under SFDR (which have a specific investment percentage committed to sustainable investment or exclusively make sustainable investments) if the investment: (i) contributes to an environmental or social objective; (ii) does no significant harm (DNSH) to any other environmental or social objectives; and (iii) follows good governance practices. The EC also acknowledged that the sector may benefit from additional guidance on this matter. Market commentary suggests that some Article 8 funds have pivoted, showing a significant increase in exposure to aerospace and defence. However, this shift has not been replicated by Article 9 funds, which (with some exceptions) appear to remain reluctant / unable to link defence investments and their sustainability objectives.

5. There is a growing number of defence-specific funds in the market and many existing strategies are being repackaged or refocused. In terms of LPs, single or multi-family offices are noted as particularly active and less sensitive to policy and public perspectives compared with larger institutional investors, although demonstrating a track-record in defence investments remains a challenge for emerging managers. Several large European LPs are now adapting their ESG policies to allow for defence investments, whereas a number of US LPs have been active in the space for some time.

6. **“Controversial weapons” remain largely out of bounds as a result of a mix of exclusion rights and policies, and restrictions derived from legislation and guidelines.** Under the **Commission Delegated Regulation** supplementing SFDR, these are defined as “anti-personnel mines, cluster munitions, chemical weapons and biological weapons”, but are defined differently in Paris-Aligned Benchmark and Climate Transition Benchmark exclusions. The EC has indicated that it intends to address this inconsistency. Further, the **ESMA fund naming guidelines**, in force since November 2024, provide that funds using terms linked to ESG or sustainability must not invest in companies involved in controversial weapons.

7. **Beyond controversial weapons, other direct and indirect or adjacent sub-sectors may be considered compatible with sustainability, for example satellite technology or transport.** “Dual-use” products (which have a military or national security application as well

as civilian use) are often subject to enhanced regulatory scrutiny and can raise specific ethical challenges from investors who did not anticipate the defence-related “use” of a particular product.

8. **Pre-deal diligence is critical against this backdrop.** Potential investments need to be screened rigorously to ensure they meet the applicable ESG criteria and do not fall within relevant exclusion criteria. This can also involve complying with the **United Nations’ Sustainable Development Goals** and the **OECD Guidelines for Multinational Enterprises** as minimum standards. This diligence should be considered from fund investment restrictions, investor side letters and SFDR perspectives, as well as based on the asset itself and processes should be robust and well-documented, in case of future challenge. Diligence for defence assets should also involve various other specialist elements, including relating to relevant foreign direct investment regimes and export control regimes.

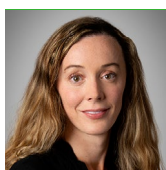
For More Information

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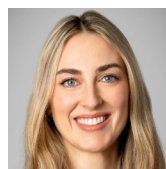
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