



CONVENTIONAL ARMS TRADE: AN EMERGING REPUTATIONAL RISK FOR INVESTORS





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SUMMARY

Although most investors do not oppose the defence industry in general, many take a firm stand against the use and trade of controversial weapons. The main reason for avoiding such investments stems from humanitarian concerns related to the indiscriminate nature of these weapons during and after armed conflicts, and the fact that they are banned or regulated by international agreements. Currently, investors face reputational risks of a similar nature associated with another controversial aspect of the defence industry, namely trade in *conventional* arms to countries that have repressive regimes, poor human rights records, and/or are in a state of conflict. A recent example of this risk was seen in the extensive media outcry related to western companies that have supplied arms to Libya. Although this trade was legal, investors in the Netherlands and elsewhere are nonetheless under fire for their investments in these companies.

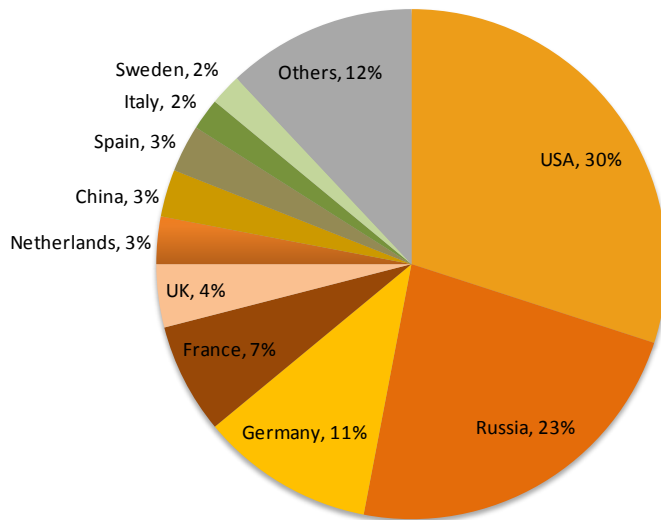
The investor risk related to this topic is likely to increase now that civil society groups are refocusing their campaigns from controversial weapons, such as cluster munitions and anti-personnel mines, to the regular or conventional arms trade. In addition, negotiations on a new arms trade treaty are likely to lead to continuous reputational and regulatory risk exposure for companies that ship arms to controversial regimes. Responsible investors are advised to consider adjusting their investment policies with regard to those companies, and possibly countries, involved in the most dubious forms of arms trade. This may involve adopting a policy addressing:

- Companies involved in *illegal* arms trade, in breach of international sanctions.
- Monitoring the end-use of the *legal* arms trade. This would mean defining criteria aimed at avoiding investments in companies known for recurrent controversial shipments to conflict zones or human rights abusers.

This paper will provide a background on the conventional arms trade and include recommendations to investors on how to manage related risks.

FROM CONTROVERSIAL ARMS TO CONTROVERSIAL ARMS TRADE

Top 10 Arms Exporters 2006-2010



Source: SIPRI (www.sipri.org)

The recent media outcry over the arms trade to Libya focuses on one particular incident and ignores the broader issue of arms trade with controversial regimes. Libya is one of many dubious end-users that European Union (EU) arms companies, and companies within emerging markets, have exported to in recent years. Often these deals take place with the active involvement and approval of EU member state ministers.

EXPORTING STATES

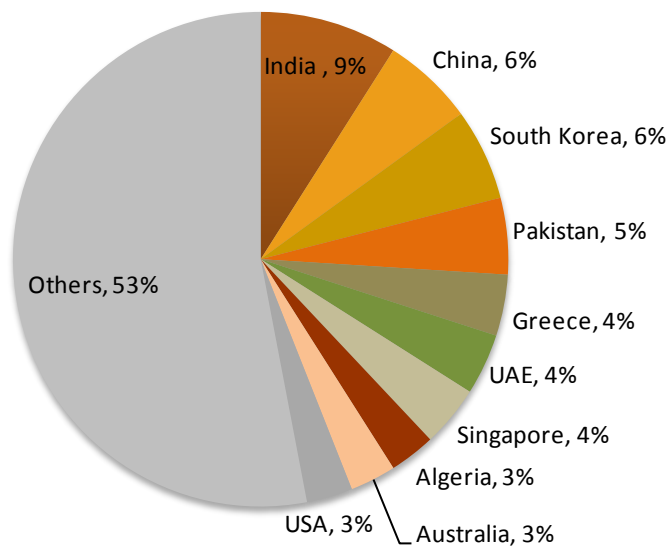
According to the Stockholm International Peace Research Institute¹ (SIPRI), arms sales generated by the world's 100 largest arms companies totalled USD 385 billion in 2008. In the same year, arms maker BAE alone produced arms worth more than the total gross domestic product of a number of the 105 countries ranked by the World Bank. The world's largest arms producers, including Lockheed Martin, BAE, Northrop Grumman and General Dynamics, are predominantly based in the western hemisphere. As a result, the bulk of global arms exports (approximately 68 per cent) originate from the U.S. and the EU. Examples of other big arms-producing countries include the Russian Federation, China, Pakistan and the Ukraine, as well as fast growing arms exporting states like Israel, South Africa, Singapore and Venezuela.

IMPORTING STATES

According to SIPRI, East Asia, Europe and the Middle East were the largest recipients of conventional arms from 2004 to 2008, each accounting for about 20 per cent of all imports. China was the largest importing state during this period, followed closely by India. When considering the implications of the arms trade, it is imperative that investors be aware of the scale of poverty, internal and external conflict in some of these countries that import arms. In 2008 alone, Africa, South America, Asia and the Middle East cumulatively spent approximately USD 900 billion on importing conventional arms.

Oxfam International and Amnesty International concluded that these exorbitant expenditures are one of the main reasons why states fail to meet the UN Millennium Development Goals (MDGs). It is worth noting that one in three developing countries spend more on defense than on health care. The Democratic Republic of Congo (DRC), Ethiopia, Colombia, Venezuela, Chad, Pakistan, South Africa and Algeria are among the developing countries importing relatively large amounts of conventional arms.

Top 10 Arms Importers 2006-2010



Source: SIPRI (www.sipri.org)

ARMS EMBARGOES

The adoption of a United Nations (UN) arms embargo requires the full support of the UN Security Council. Often this decision is highly politicized and the current list of countries under such an embargo is debatable. To date, UN embargoes are imposed against Iran, North Korea, Sierra Leone, Eritrea and others. As of February 2011, Libya was also included in this list. Yet many countries with poor human rights records are not subject to an embargo; for instance there is only a partial embargo against Sudan which only applies to arms that may be misused in Darfur. Another example of a serious human rights violator, to which only an EU arms and U.S. embargo applies, is Myanmar. The EU has established its own list of embargoed states, which includes countries on which the Security Council has failed to reach a consensus such as China, Myanmar, Zimbabwe, Lebanon and Uzbekistan. Given the issues outlined above, it is important for investors to note that not all problematic end-users are subject to embargoes.

ARMS TRADE LEGISLATION

Arms transfers from the EU or U.S. are subject to relatively strong export legislation, such as the U.S. International Trafficking Arms Regulation or the EU Common Position on arms exports. These standards integrate criteria related to maintaining peace and respecting human rights, though their effect is debatable. The EU Common Position on arms exports particularly states that no licence may be approved if "there is a clear risk that the military technology or equipment to be exported might be used for internal repression." However, the controversial shipments to Libya indicate that current EU legislation, while considered to be the strictest in the world, still fails to prevent the flow of arms to dictatorial regimes or regimes known for their widespread human rights violations. As a result, the

An average of US\$22bn a year is spent on arms by countries in Africa, Asia, the Middle East, and Latin America – a sum that would otherwise enable those same countries to be on track to meet the Millennium Development Goals of achieving universal primary education (estimated at \$10bn a year) as well as targets for reducing infant and maternal mortality (estimated at \$12bn a year).

Source: Shattered Lives: the case for tough international arms control, Amnesty International, 2003

EU arms exporting regulations cannot be considered fully effective, especially due to serious discrepancies between the member states' interpretations of what is allowed under EU legislation.

Many other large arms producers are based in emerging markets (EM) countries. While some form of legislation regarding arms exports may exist, they often fail to integrate strict human rights criteria. Therefore, it is considerably easier for companies operating in these countries to obtain a permit to ship arms to dubious end-users, or the state itself may supply arms to a range of offenders. Large arms producing emerging market countries such as the Russian Federation, China, Pakistan, Ukraine, Israel, South Africa, Singapore and Venezuela are involved in arms trade with dubious regimes.

Although the effectiveness of current legislation is strongly dependent on the exporting state, even the strictest regimes are involved in trade to conflict zones and human rights violators. Due to the social and economic impacts of the arms trade to sensitive states and regimes, civil society organizations and a number of states have called for a new arms trade treaty to harmonize export legislation around the world based on strict human rights and peace-related criteria. Negotiations with the UN are currently ongoing.

EXAMPLES OF CONTROVERSIAL TRADE

As a result of the gaps in current legislation, various recent examples of controversial trade can be found:

- According to EU figures, in 2009 EU member states granted export licenses worth EUR 343 million (USD 470 million) to Libya which included aircrafts, small arms, rockets, grenades and a range of supportive military technology. The companies involved include Finmeccanica, BAE and others. Though difficult to prove, it is likely that some of this technology is being used to repress the opposition. That said, these shipments to Libya were fully legal since the EU member states themselves approved the arms export licences through their regular arms

exporting process. A new arms embargo was adopted in February 2011 and will end arms shipments originating from companies within the EU to Libya.

- According to a report by the Control Arms Campaign², in recent years, the Russian Federation has supplied attack helicopters to Ethiopia, India and Uganda; missile launchers to China and India; and Antonov planes to Sudan. Russia has exported a range of other conventional weapons or military services and equipment to countries such as Algeria, Myanmar, Iran and China. Some of the shipments were allegedly used for the commission of human rights violations. For instance, Antonov planes were used for indiscriminate bomb attacks on villages in Darfur. Russia's state arms export enterprise, Rosoboronexport, has allegedly shipped arms to Iran and a number of conflict regions in Africa.
- In 2006 BAE and its South African subsidiary Land Systems OMC, were accused by a number of non-governmental organizations (NGOs) of exporting armoured vehicles to Uganda despite concerns that armoured vehicles had been used to commit or facilitate human rights violations in this country. The company has also been linked to various other controversial and corrupt arms deals.
- In 2004, the Brazilian company Embraer entered the list of the world's top 100 arms producers. The company has delivered military aircraft to Colombia, where there is a clear risk of their misuse in the country's internal conflict. In addition, the company has allegedly delivered arms to Egypt, Thailand and subsidiaries of private military companies in the U.S. known to be linked to human rights violations.
- According to a report by Amnesty International,³ internal conflict in the DRC, fueled by a continuous supply of arms to all groups involved, has resulted in an estimated three million casualties throughout the last decade. China, Russia, Albania, South Africa, Egypt and France have been implicated in supplying weapons thus enabling all groups to carry on their military activities. The arms trade was also partly fueled by the exploitation of coltan, a high value mineral used by several western companies.

INVESTOR RISKS**LEGISLATIVE RISKS**

In principle, trading in arms is considered legal unless it is in violation of national export legislation or EU or UN arms embargoes. As discussed above, the current list of embargoed countries includes well-known human rights violators. There will be significant risks to investors linked to a company or state that violates a UN arms embargo, as it will likely lead to international condemnation and criminal investigations. However, such consequences are rare since a large part of the arms trade takes place in a legal grey zone. Dubious shipments are not considered illegal simply because there is no adequate legislative framework in place to tackle this issue.

States have adopted treaties on a wide range of issues yet, remarkably, no comprehensive international binding standard exists for the regulation of trade in conventional arms. Due to this legislative gap, civil society has called for an international arms trade treaty. UN negotiations on this topic are currently underway and 152 countries have already expressed their full support to adopt such a treaty by 2012. This initiative aims to ensure that all export permits have to meet criteria related to poverty, human rights and peace. Once adopted and fully functional, the treaty will impact large defence-related companies as it should become harder to obtain an export license for arms shipments to controversial regimes. This, in turn, should result in a decrease in the number of controversial end-users that receive arms. Once the arms trade treaty is adopted, investors will want to avoid companies that are operating in violation of this treaty. Civil society may also use the treaty to initiate lawsuits against states or companies involved in conventional arms trade to controversial states, particularly when the trade involves western countries. As long as the treaty is not in place, or fully effective, dubious arms trading with countries like Libya will continue to be exposed.

Poverty **Armed conflict**

Armed conflict **Poverty**

Poverty fuels conflict: As per capita income halves the risk of civil war roughly doubles.

Conflict fuels poverty: A typical civil war leaves a country 15% poorer, with about 30% more people living in absolute poverty.

Source: Shattered Lives: the case for tough international arms control, Amnesty International, 2003

REPUTATIONAL RISKS

Irresponsible trade in conventional arms, and arms trade with dubious end-users, kills an estimated 300,000 people a year, far more than the number killed by controversial weapons. Increasing arms imports have been proven to initiate, fuel and/or exacerbate conflict and allow tyrannical regimes to remain in power. As a result of serious loopholes in existing legislation, as is the case in the EU, arms may end up in the hands of dubious end-users. This process is also facilitated by complex brokering activities, arms re-transfer, components trade, the lack of end-user controls and by the practice of licensed production overseas in countries with limited or no export legislation. Arms, including those produced by western companies, may therefore still end up in the wrong hands and investors face serious risks related to possible public exposure.

Leading news sources and NGOs, such as Amnesty International, Oxfam International, Global Witness and many others, have published extensive reports on the human rights impact of irresponsible arms trade and have pointed out some of the worst performing companies and countries. Several of these reports have specifically targeted the role that investors have played in this industry. NGOs have shifted their attention from controversial weapons, such as cluster munitions and landmines covered by treaties, to the conventional arms trade. The ongoing negotiations for the adoption of an arms trade treaty is expected to further raise NGO and media awareness of this issue in the coming years and increase the risks for investors linked to some of the more questionable arms producing companies.

PHYSICAL AND MATERIAL RISKS

As mentioned above, the arms trade has been shown to initiate, fuel and/or exacerbate conflict and lead to an increase in human rights violations. The instability created in affected countries has negative impacts on economic progress and leads to an unstable operating environment for companies. Conflicts, even at the local level, may involve a range of material risks such as project delays, damage to property, threats or attacks on employees, and unpredictability with regard to

The arms trade is “arguably the most corruption-prone of all international businesses.”

— *Transparency International*

obtaining the necessary government permits for operations. In addition, conflict zones or regimes violating human rights are often characterized by non-functional or weak legal systems, a restricted civil society and the lack of a responsible and professional security apparatus. This, in turn, results in a lack of oversight on business operations, allowing some companies to become involved in controversial activities such as the exploitation of natural resources. In this context, scandals and human rights incidents are more likely to occur and will create additional risks for investors. In sum, companies operating in conflict zones fueled by increasing amounts of arms are at a constant risk of becoming entangled in human rights violations.

CORRUPTION RELATED RISKS

According to Transparency International, the arms trade is “arguably the most corruption-prone of all international businesses.”⁴ As an example, in January 2010 it was reported that the Employees of the City of Harper Fund, a U.S. pension fund, plans to ask the Supreme Court to let it sue BAE Systems Plc in the U.S. over allegations that the company paid more than USD 2 billion in bribes to win a record Saudi arms deal. The company has already undergone a legal process in the UK regarding this controversial deal. Although most responsible investors have adopted policies on corruption, the specific issues pertaining to the defence industry require additional attention.

MANAGING THE RISKS

A growing number of responsible investors screen their portfolios for arms companies producing controversial weapons. At the same time, some investors may have adopted policies with regard to specific business activities in problematic countries, such as Burma or Sudan. Yet, as noted above, these countries are not always covered by full UN embargoes. As a result, investors should consider addressing the risks related to conventional arms trade more comprehensively. A policy that strives to prevent involvement in the most controversial forms of arms trading could be based on the following elements:

Illegal arms trade

Financial institutions want to avoid being linked to companies that are clearly in breach of international law by violating an arms embargo. Involvement with violators may lead not only to a reputational risk, but the accused company may also be subject to severe repercussions such as lawsuits. Therefore, as a first step, investors may adopt a policy statement that they will exclude any company said to have breached a UN or EU embargo. Although such scenarios are unlikely for listed companies, they could occur incidentally.

Controversial end-use

A policy on controversial end-use would not exclude the overall defence industry, but would avoid the most questionable forms of arms exports and the companies involved. Such a policy may include:

- **Defining high-risk end-user countries:** As a best practice some investors have established criteria related to the end-use of the defence industry. Currently the term *dubious end-user* has not been internationally defined. However, as an example, there is a clear distinction between arms shipments from the EU to NATO forces in Afghanistan, aimed at strengthening the Afghan national army, and the shipment of heavy machine guns to rebel groups in the DRC, known for their systematic attacks on civilians. An investor may proceed by setting his own controversial end-user categories, such as military regimes; dictatorships; regimes structurally involved in the most serious human rights violations, such as genocide, war crimes or crimes against humanity; or countries involved in a long-term conflict. As a next step, investors may then monitor companies that are repeatedly shipping to these dubious end-user categories.
- **Establishing an export licence requirement:** Some investors have defined a criterion which states that they will only invest in defence-related companies able to demonstrate export licenses based on effective national export regulations. Companies in western markets will be able to demonstrate such a license. Although such a requirement does not always provide

optimal results, it is likely to have an impact on companies operating in weak or non-existing arms exports regimes.

- **Engaging on end-users controls:** The defense products produced by most large western arms producing companies, such as Lockheed Martin, Northrop Grumman and BAE Systems, are by most not considered controversial. However, there may be instances in which such companies are linked to alleged arms shipments, whether accidental or not, to dubious end-users. In these cases, especially when these occur repeatedly, investors could use their engagement policy to inform the companies about the allegations or to ask for steps to prevent further shipments and improve end-user controls.
- **Excluding companies operating in countries with weak export controls:** As mentioned earlier, major arms producing companies that operate outside the U.S. and EU are more likely to ship to dubious regimes. Therefore investors may consider adopting exclusion policies for arms companies operating in these countries.
- **Other policies:** Other policy angles may also be explored, such as engagement with defence companies that actively lobby against stricter arms export legislation. As with controversial weapons, investors may also assess the proportion of total revenues obtained by a company from the arms trade, to identify companies for divestment.

¹ SIPRI Yearbook 2009: <http://www.sipri.org/yearbook>.

² Initiative by Amnesty International, Oxfam and IANSA: www.controlarms.org.

³ Amnesty International report Shattered Lives: the case for tough international arms control, 2003
http://www.amnestyusa.org/arms_trade/controlarms_report.html.

⁴ Transparency International: Corruption in the Defence Industry, 2006
http://www.transparency.org/news_room/in_focus/2006/defence_sector.

State bonds

There are two categories of countries that are most likely to be associated with arms exporting related risks: the main exporting countries without adequate arms export regulations and the major arms importing countries from emerging markets. Investors with significant state bonds in these countries may want to reflect on how their investments relate to military activities and payments, especially when it concerns countries spending millions on arms instead of on the Millennium Development Goals.



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