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ESG performance and cannabis

Environmental, social and governance performance

Kellie L. Johnston and Andrea Brewer

The link between positive environmental, social and governance (ESG) performance and economic growth is not new. However, the heightened focus by market participants on value creation through sustainability is new and being driven in part by global trends related to stakeholder ESG awareness and the role of business in society. [ESG and sustainability are used interchangeably throughout this paper.]

With the realities of climate change looming large and an increased focus on human rights, cyber security, technology and the role of business in society, ESG is garnering increased global attention, especially in emerging industries, and the cannabis industry is no exception. Investor and consumer interest, as well as enhanced legislative requirements are all significant drivers in ESG development.

This paper explains ESG fundamentals and how implementation of sustainability strategies can help companies in the cannabis industry differentiate themselves and set the groundwork for future success in a changing business environment.

What is ESG?

ESG refers to the environmental, social and governance factors that are now considered key to financial growth and long-term value creation in companies, globally. One of the biggest drivers in this area is investor interest. Another major driver is consumers who are becoming increasingly interested in where their products originate, their health and safety characteristics, and their impacts on people and the environment. A growing volume of evidence shows companies that manage material and non-material ESG issues have a lower cost of capital, demonstrate better financial performance over the long-term and have a better share price.

New regulatory requirements, emerging in jurisdictions across the globe, and the identification of global sustainability goals have also significantly influenced the importance of ESG issues in today's marketplace. Additional influences include an increased focus on sustainable finance; the development of ESG-focused non-govern-

mental organisations, and an increased global focus on the attainment of the United Nations Sustainable Development Goals (SDGs). The SDGs are 17 global goals set by the United Nations General Assembly in 2015 to be attained by 2030—essentially the world's 'to do' list. The goals include considerations related to good health and well-being, decent work and economic growth, responsible consumption and production, and climate action.

Why it matters

Investors care

Investors around the world view companies that ignore or disregard the importance of ESG issues to be a significant risk to their portfolios. Specifically, investors in the cannabis industry have seen significant share price volatility and many institutional investors have been hesitant to invest in cannabis companies, for reasons that include weak corporate governance management approaches as well as poor management of environmental and social risks. Those that do invest in the industry may be motivated to actively influence a company to address sustainability issues through proxy voting and direct engagement with management and the board.

Institutional investors have for a number of years included sustainability criteria in their investment assessments and valuation decisions. In Canada, for example:

- 80% of institutional investors in Canada use ESG principles as part of their investment approach.[1]
- Assets in Canada being managed using responsible investment strategies increased from CAD$1.5 trillion for the year end 2015 to CAD$2.1 trillion for the year end 2017.[2]
- In 2018, 97% of institutional investors said they conducted evaluations of target companies' non-financial disclosures, which is a 20% increase since 2017.[3]

These statistics indicate that it is critically important for all companies, including cannabis companies, to address ESG risks and opportunities in their organisations through implementing ESG (including sustainability) strategies to ensure that sustainability risks are identified and mitigated and the corresponding opportunities can be realised to improve corporate value.

Increased regulation

Another important reason to consider ESG factors is the increasing regulatory framework being implemented in relation to sustainability issues. Publicly reporting cannabis companies are already familiar with the breadth and scope of disclosure required of them on a periodic and ongoing basis in relation to all material information affecting their businesses. However, in 2019 there have been significant regulatory developments. The EU adopted the Disclosure Regulation which requires investment managers to disclose to end investors how sustainability issues affect the value of an investment and whether the investment's societal impacts have been considered more broadly.

In Canada, changes to the Canadian Business Corporations Act provide a more inclusive and broader vision of stakeholder interests when the board is considering the best interests of the company. In addition, cannabis companies, particularly producers, are operating in an industry with direct environmental impact where disclosure around sustainability will be material and therefore required.

The legal landscape is changing rapidly in relation to sustainability issues. Getting ahead of ESG risks (and related disclosure) with internal, robust management of sustainability risks can be advantageous for cannabis companies, particularly as the industry grows and its ESG impacts become better understood by its stakeholders.

Increasing litigation and shareholder activism

Litigation risk is prominent and gaining momentum in relation to sustainability and ESG matters, particularly with respect to climate change actions. Environmental groups, investors, and government agencies are increasingly focused on risks related to climate change. These efforts have spanned more than a decade and, in addition to traditional lobbying efforts, groups have used a variety of approaches, some of which are novel and creative, in their attempt to have private companies address these issues.

Novel legal claims are growing in popularity, including common law tort claims against companies for their perceived contribution to climate change. Some plaintiffs have sought to use existing environmental statutes to sue for injuries related to climate change. Other groups have used financial disclosure laws to pressure companies to increase the amount of information they disclose about their emission of greenhouse gases and their plans to minimise those emissions. The groups pursuing these efforts are often sophisticated parties, including significant institutional investors. The primary purpose of many of these lawsuits is to raise public awareness of perceived issues or failures with the target organisation. The risks posed by these lawsuits are real, and the cases may impact a company's reputation and require significant management time and resources to defend, even if the plaintiffs do not prevail in the end.

In addition, over the past decade, investors have increasingly launched shareholder proposals on environmental issues, with a particular focus on climate change, and increasingly on social and governance issues such as gender and racial diversity on the board. These proposals often request companies to adopt environmental and social policies as well as enhanced disclosure practices. In Canada in 2019, there were nine proposals to adopt ESG metrics as part of executive compensation decisions. In prior years, ESG proposals were often excluded from companies' proxies when received and when they were submitted to a shareholder vote, they often garnered little support. However, shareholder proposals focused on ESG matters now appear on proxies with

The quote

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greater frequency globally and, in Canada for example, have received growing support from shareholders: in some cases greater than 50% of the votes received.

The pressure exerted by institutional investors and individual shareholders alike are compelling all companies to manage their ESG risks, regardless of industry, and disclose these activities in their regular disclosure. These risks, in addition to climate change, include board gender composition, workplace culture, human rights, anti-bribery and anti-corruption efforts, data privacy and cyber security. The aforementioned issues are increasingly being perceived by investors as material to corporate performance, and therefore this information is seen as helpful in gauging the likelihood of financial impact on the performance of the company.

Global trends

One major continuing global trend is the shift from the theory of shareholder primacy in corporate decision-making to the inclusion of non-shareholder interests, creating long-term value, financial gain and better serving all stakeholders. In 2019 BlackRock, Inc.'s (BlackRock) CEO Larry Fink issued a letter to all CEOs of publically traded companies warning that BlackRock will be asking how companies integrate ESG principles into their long-term strategy and management. BlackRock's statement was followed by a statement from The Business Roundtable[4], acknowledging that while each company serves its own purpose, "we share a fundamental commitment to all of our stakeholders" and "each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country". This is a fundamental shift for The Business Roundtable, who before the release of the statement in August 2019, wholly endorsed the principle of shareholder primacy.

Most recently, Blackrock published its 2020 letter to CEOs and in it stated that they will "be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans that underlie them."

The other realities at play include the global drive towards a low-carbon and climate resilient economy, as well as recognition that private investment and innovation, as opposed to strictly government operations, are needed to contribute to a more just and healthy global economy—the global SDGs.

ESG issues in the cannabis industry

Environmental risks

Climate change, packaging and agricultural practices represent some of the most significant risks related to the environment for cannabis companies in the global transition to a low-carbon economy. Growing of cannabis requires optimal temperatures, humidity and lighting conditions and much of it is grown indoors or in greenhouses. These methods are energy intensive and could result in large carbon footprints. As public awareness about the carbon footprint of cannabis grows, investors may be reluctant to invest in companies that do not take strides to reduce their energy use or implement strategies to reduce environmental impacts. Many groups are divesting funds from industries seen as having negative effects on climate.

Waste reduction and plastic packaging is an area in which the cannabis industry will certainly benefit from innovative solutions to these challenges. This is especially so in Canada, where medical and recreational cannabis is legal across the country, given the current Canadian regulatory requirements for labeling and packaging, which makes it very difficult to reduce waste and use less plastic. Opportunities will be present for those companies that can innovate in this area and meet the challenge of environmentally-friendly packaging within the existing regulatory framework—they stand to gain credibility and trust.

Agricultural practices, including related to indoor operations, also represent an area of significant risk for the cannabis industry, specifically related to pesticides. For example, in Canada, in the event that unauthorised pesticides are found in testing, Health Canada may seize and destroy product, recall product sold to customers, suspend or revoke a company's licences or issue a monetary penalty of up to $1 million. Additional compliance actions may be taken under the *Pest Control Products Act*.[5] Not only do agricultural practices represent a significant area of risk in relation to regulatory compliance and consumer health and safety, but also pose potential litigation, financial and reputational risk.

Social risks

Social risk also presents challenges for fast-growing companies like those in the cannabis industry. In the social realm, some of the main risks for the cannabis industry include quality control and product safety as related to the health and safety of consumers. These risks relate most directly to litigation risk and reputational risk (including unwanted media attention), both of which can have significant financial, brand and consumer trust impacts.

In addition, it is important that the cannabis industry works to maintain its social licences to operate. Focusing on consumer education that promotes responsible use, investing in research to build reputable scientific evidence identifying the benefits and risks related to cannabis, and investing and engaging with communities to build positive relationships where cannabis businesses operate, are all important activities to help build and maintain the industry's social licence to operate.

Governance risks

Cannabis companies have experienced exponential growth and, as a result, some have found it challenging to scale-up their corporate governance controls to keep pace with their growth and the increased regulatory, investor and consumer scrutiny. It is critical for compa-

nies to maintain independent and knowledgeable board oversight to meet the regulatory and compliance and ethics demands in this new industry. Many of the class action lawsuits ongoing against cannabis companies, in Canada and the United States for example, relate to misrepresentations and disclosure concerns. Often the source of these issues relate to a failure or perceived failure around the governance process related to decision-making surrounding such events.

Implementing good corporate governance controls, such as independence of board members, avoiding self-dealing and setting up robust oversight of regulatory compliance systems to ensure compliance and accountability will go a long way in establishing credibility and avoiding potentially significant decreases in stock prices, litigation and damage to reputation.

Diversity is also a critical component of governance risk. Investors are increasingly demanding gender equality and diversity on boards that reflect the communities where companies operate, in addition to diversity on boards in experience and knowledge. In addition to women holding board seats, investors are seeking board members who reflect the expertise relevant for the age and stage of the company. They carefully review skills matrices to determine the real skills needed to take the company through its next stages of development.

Tools for risk mitigation and management

When considering risk mitigation of ESG factors, companies should be considering the following questions:

- Have we done a risk assessment to determine material ESG risks?
- Is our corporate strategy aligned with our sustainability goals and embedded throughout the company?
- How well are we identifying, assessing, managing and disclosing our sustainability risks?
- Have we set metrics and targets to meet ESG goals and identified risks?
- Does our reporting strategy support and reflect the value our company creates?
- Should we consider incorporating the UN Sustainable Development Goals in our corporate strategy?
- Is there information we could share that would enhance our 'brand'?

In addition to questions companies should be considering to mitigate risks, executives and boards should consider the following:

- Do we have a corporate governance structure in place that meets regulatory and stakeholder demands, and best practices?
- Do we measure where our company falls on various environmental and social factors?
- How do we engage with various stakeholders, including investors, regulators and community groups, and do we report on the measured metrics, targets and engagement with stakeholders?

Opportunities for development

After companies ask themselves the above difficult questions, they can begin to develop their ESG policies and procedures. The following is a list of ways in which cannabis companies can begin this process:

- Start with a risk assessment to determine your ESG risks and opportunities.
- Build a compliance and ethics program from scratch. Doing so will offer opportunities to customise the program to your company's needs and build a culture of sustainability and compliance from the ground up. Such a culture can be a great tool to mitigate risk and foster innovation.
- Take active steps to meet ESG standards now by considering environmental, social and governance practices throughout the company and its supply chain. Compliance today will better position cannabis companies to comply with ESG-related legislation in the future and meet changing stakeholder demands in this area.
- Consider your company's brand and reputation. Regulatory restrictions on brand promotion and labeling, such as those that are in place in Canada, can provide a unique opportunity for companies to distinguish themselves in their respective industries by building their brand or reputation, in part, on sustainability credentials.

Conclusion

Cannabis companies have a unique opportunity in a new industry to establish sustainability strategies, procedures and processes from the ground up to better meet growing global ESG demands as the industry matures. Companies will benefit from paying attention to their environmental, social, and governance risks and take steps now to identify them and take proactive mitigation steps. Doing so could result in operational, reputational and financial benefits accruing to early adopters and improve public perceptions of the industry as a whole.

Notes

1. RBC Global Asset Management, 2019 Responsible Investing Report Executive Summary [https://www.rbcgam.com].
2. Responsible Investment Association, 2018 Canadian Responsible Investment Trends Report Executive Summary [https://www.riacanada.ca/research/2018].
3. EY, CCaSS Survey 2018 Report [https://www.ey.com].
4. The Business Roundtable is an DC-based association of chief executive officers from major companies in the US that promotes public policy relating to business interests. It focuses on research and advocacy to effect change in the US in connection with job creation, US global competitiveness and economic strength.
5. SC 2002, c 28 (PCPA).