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PERSPECTIVE

Environmental, Social and Governance (ESG) Trends: Why it's important and what you need to know

The intervention of partisan politics into ESG in 2022, particularly in the U.S., has continued to occupy the public spotlight in 2023. At the same time, more organizations are recognizing the importance of robust ESG programs to better manage risk and drive opportunities. Despite the impact of a sluggish global economy and the ongoing war in Ukraine, ESG investing has demonstrated resilience and continues to evolve.

Now, more than ever, ESG requires a measured and balanced approach. On one hand, environmental advocacy groups are utilizing available legal processes to initiate greenwashing claims against high-profile companies, accusing them of inadequate efforts. On the other hand, there are investors and stakeholders who are penalizing companies for being "too woke."

We are closely monitoring the evolution of three significant trends in ESG. Firstly, we observe a continuous transition from soft law voluntary standards to stringent legal requirements, as exemplified by our spotlight on labor and employment. Secondly, there is an ongoing shift

towards harmonization and standardization of terminology, addressing a crucial need within the industry, as highlighted in our spotlight on investment management. Lastly, there is an increasing acknowledgment of the significance of robust ESG-I programs that acknowledge the unique history and legal position of Indigenous communities in Canada, as explored in our spotlight on Indigenous matters.

ESG permeates all areas of a business and the associated legal implications are far-reaching. In many areas of practice, organizations are being judged on their current, future and past performance.

This report is designed to help your organization familiarize itself with the shifting landscape, identify potential areas of concern and proactively take steps to fine-tune your ESG stance. Use it to direct these important conversations and uncover practical ways to leverage the opportunities and mitigate the risks of ESG at your organization.

Spotlight on: Investment management

Lynn McGrade

A push toward regulatory clarification

Although ESG funds continue to grow in popularity, the rules and regulations around them have—for the most part—been rather lax, making it difficult for investors to spot greenwashing. This is something the CSA sought to rectify in January 2022 when it released guidance that encourages greater disclosure on matters such as ESG objectives and strategies, proxy voting, shareholder engagement and naming conventions. This guidance was the subject of ongoing audit reviews by staff of various provincial securities regulators throughout the latter half of 2022.

In April, the Canadian Investment Funds Standards Committee (CIFSC) released an identification framework aligned with global developments to assist Canadian investors through common language and definitions. To be considered a Responsible Investment (RI) fund under this new framework, a fund must have an RI/ESG investment mandate and meet the criteria of at least one of

the framework's outlined approaches: ESG Integration and Evaluation, ESG-Thematic Investing, ESG Exclusions, Impact Investing, ESG-Related Engagement and Stewardship Activities, and ESG Best in Class.

Beyond these two changes, the SEC in the United States also came out with proposed requirements surrounding ESG fund disclosures, which would introduce new disclosure and other requirements applicable to funds and investment advisors that use ESG factors when making investment decisions and setting strategy.

Why it matters

As funds update their prospectuses throughout the spring and summer months, they will need to comply with a range of evolving disclosure requirements. Since different regions around the world have different approaches, understanding this new guidance and developing a consistent global approach can be difficult. A thoughtful approach to ESG disclosure is important as we have seen a number of investment fund managers in the United States face litigation around disclosure issues in 2022—indicating that liability exposure is definitely on the rise.

Things to think about

Investment fund managers need to make sure they have taken the appropriate steps to protect themselves from greenwashing claims. This involves understanding the developing industry standard for disclosures in Canada, as well as the United States and Europe, if they are applicable. This will help managers prepare their disclosures for their Canadian prospectus. Policies, procedures and documentation to support the disclosure are also essential.

Throughout 2023, we will have a better idea of how regulators are interpreting the CSA's new guidance—and the industry should have time to reflect and, if necessary, push back. Companies would also be well-served to keep an eye on what happens in the United States as the recent proposals become finalized. In certain circumstances, it might make sense to take steps to streamline disclosures. Beyond that, it may be time to focus on other areas of the guidance—including things like policies and procedures, proxy voting guidelines, and even sales and communications policies.

Spotlight on: Litigation, disputes and claims

Laura M. Wagner & Rick Williams

In 2022, we saw high profile complaints against manufacturers and financial institutions resulting in fines and penalties.

Internationally, we saw a new trend: private action greenwashing claims between industry players. One example came out of Italy, where a company in the textile industry obtained an interim injunction against its competitor to stop it from making false and misleading greenwashing claims. It is, therefore, likely only a matter of time before we see cases in Canada.

What is also gaining increased traction is the concept of greenwashing whistleblowers. If there is a disconnect between what a company's C-suite knows and what a company is disclosing to the public, its employees can be expected—more and more—to bring that information forward to the public themselves.

Why it matters

Over the next few years, we will see more evidence of the fact that regulators are not the only bodies that have an interest in your ESG claims—your competitors and employees are scrutinizing them as well. This underlines the ongoing and continued need to proactively and carefully review your ESG disclosures before they are made public.

It is also increasingly important to be thorough in your organization's disclosures. If you have an international supply chain, for instance, you need to be fully aware of how it operates, not only in Canada, but abroad.

These steps are important and not just to preserve your organizational reputation or avoid litigation. Every time one of these greenwashing cases arises, it impacts the public's perception of all ESG claims and, as a result, their overall impact.

Things to think about

Understanding your reporting obligations, scrutinizing your disclosures and making sure your data is supported and backed by management are all good ESG practices that will become more important in the coming years.

A good corporate disclosure policy includes processes for preparing, reviewing, testing and approving your ESG statements, whether voluntary or required, and avoiding embellishments (such as marketing claims that cannot be backed up with data). When in doubt, focus on the facts and avoid any claims that cannot be tested and confirmed.

Finally, taking a hard look at your global supply chain will come in handy in the near future, particularly when the *Fighting Against Forced Labour and Child Labour in Supply Chains Act* comes into force on January 1, 2024. The Act will require mandatory reviews and reporting for many companies with a Canadian presence.

Spotlight on: Financial services and sustainable finance

Tiffany Murray

Financial institutions go all-in on ESG

Canada's financial institutions have been a driving force in the ESG movement and that trend will continue throughout 2023. Recognizing an opportunity to grow and differentiate their businesses, many financial institutions have seized opportunities to integrate ESG into their corporate and managerial structures, including taking steps to link CEO pay to ESG performance.

This has trickled down to all areas of their organizations. Most notably, we are now seeing growing commitments to greener loan portfolios, resulting in an influx of green and sustainability-linked bonds and loans. Last year, we also saw remarkable growth in financial tools to support the transition from oil and gas to renewables. These included things like transition bonds and loans and —once again—sustainability-linked loans, allowing corporate borrowers to integrate performance targets into their loan documentation such that the interest rates are tied to the targets.

Why it matters

We expect that financial institutions will continue to be leaders and develop new product offerings in 2023 and beyond. Recent acquisitions—like BMO's acquisition of Radical, a company that helps organizations reduce their carbon footprint—demonstrate a surge of momentum and, potentially, innovation in this space.

This shift will also impact the financial regulatory landscape around ESG. The Office of the Superintendent of Financial Institutions (OSFI) has started releasing ongoing information on climate risk management—and its focus on disclosure expectations that include climate considerations demonstrate that this will remain a key consideration for financial institutions.

Things to think about

For organizations not already considering sustainable finance instruments as part of their financing plans—as the market has reached a level of maturity, it may be time to consider adding them. There is a large pool of dedicated capital seeking a home in these types of instruments, making this an important area of focus for the years to come.

As banks further integrate ESG into their managerial structures, they are increasingly linking executive compensation to sustainability performance metrics. This may become a best practice in other industries as well.

We are anticipating new and more complex products and service offerings, including derivatives of existing sustainable finance offerings. Product designers will need to address considerations like double-counting concerns related to carbon emissions.

Spotlight on: Mergers and acquisitions

Kent Kufeldt & Jennifer Archer

ESG and due diligence

As ESG gains momentum, it is permeating all areas of business, including the M&A space. For many buyers, ESG is now part of the due diligence process as a strong ESG program can influence a company's ability to mitigate risk (particularly reputational risk) and, in today's market, potentially influence a company's value.

While the "E" in ESG has been front-and-centre in the M&A space for quite some time, buyers are now paying more attention to the S and G elements. In this vein, the questions surrounding ESG throughout the due diligence process have become more detailed. Buyers are now diving deeper—looking into compliance with labour laws, human rights claims and even workforce diversity.

Regulatory changes around ESG are also impacting the M&A due diligence process. Proposed Canadian legislation intended to combat the fight against modern slavery—for example—is poised to impact both public companies and institutions, leading to greater ESG disclosure requirements. As a result, potential buyers are paying closer attention to their targets' ESG disclosure statements and focusing on acquiring those companies that either support or enhance the buyer's own ESG efforts or align well with existing ESG initiatives and standards.

Why it matters

Target companies looking to sell—whether they are public or private—should integrate ESG into their organizational optimization processes, including governance practices. This may involve taking steps to strengthen ESG credentials, enhance ESG monitoring and reporting, or even monitor supply chains more closely. The goal is to demonstrate to potential buyers that, when it comes to ESG, your company "walks the talk."

Things to think about

Sellers will want to consider how they measure up against some of their potential purchasers' ESG requirements. Depending on the industry, careful attention to ESG matters could dramatically drive up a company's purchase price and/or attract the attention of strategic investors/shareholders.

This is particularly true for companies that are undertaking resource-oriented project work. For instance, investors will prefer greenfield mining developments and similar community-based projects that are proactive in building long-term partnerships with the Indigenous communities (through things like thorough consulting processes and providing impacted Indigenous communities with an equity stake in the development). It is no longer enough to go in with platitudes—a sophisticated approach is critical.

This level of ESG commitment must expand beyond the commodities industry as well. Today, a growing number of buyers across a growing number of industries are paying close attention to ESG metrics. They are scrutinizing things like governance issues, supply chains, and diversity and inclusion (and looking for diverse management teams). As ESG regulations continue evolve, this level of interest will only increase.

Spotlight on: The environment and climate change

Jonathan Cocker & Kristyn Annis

Growing action on climate change

The Clean Fuel Regulations is a notable program designed to encourage the use of low carbon fuels, technologies and processes within the transportation industry. Its primary objective is to progressively enhance the cleanliness of everyday fuels by enforcing a requirement for fossil fuel producers and suppliers to decrease the carbon intensity of their products by 2030. An essential aspect of the program allows producers and suppliers to obtain credits from third-party entities, including charging network operators and clean hydrogen producers—who specialize in fuel switching, enabling them to effectively reduce their carbon footprint. Additionally, the program encompasses a dedicated fund that aims to expedite the production and adoption of low-carbon fuels, such as hydrogen and biofuels.

Meanwhile, Canada is poised to join the growing list of countries that will soon enforce mandatory carbon emissions disclosure by companies. Currently, the Canadian Securities Administrators (CSA) and the US SEC have each introduced draft disclosure regulations, drawing inspiration from the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations. Originally expected to be implemented in April 2023, the SEC delayed its issuance of the much-debated climate change disclosure rule until at least the fall of 2023. Consequently, affected companies will not be required to disclose until 2024, considering the extended timeline. Similarly, the CSA, which unveiled its proposed National Instrument 51-107, *Disclosure of Climate-related Matters*, ahead of the SEC's disclosure standard, has also postponed the finalization of its instrument. It is worth noting that the disclosure requirements outlined in proposed NI 51-107 were perceived to be less stringent compared to those mandated by the TCFD or the SEC's proposed rule. Despite these draft rules not being expected to take effect until 2024 — numerous organizations, including pension fund managers, have already proactively adopted stricter disclosure practices as a demonstration of sound governance.

In addition to mandatory reporting, the International Sustainability Standards Board (ISSB) has finalized and issued its International Financial Reporting Standards (IFRS) Sustainability Disclosure Standards, S1 and S2. These standards, which have been globally developed, aim to establish a consistent set of accounting rules for public companies, ensuring comparability in financial statements and reporting of specific transactions across various sectors and jurisdictions. It will be up to domestic regulators like the CSA to decide whether to mandate the application of the IFRS Sustainability Standards for reporting issuers and other entities under their jurisdiction. Notably, the CSA strongly supports the ISSB and actively advocated for one of its head offices to be located in Montreal. However, many companies are voluntarily adopting the standards in anticipation of future mandatory application.

Why it matters

Organizations that have adopted a wait-and-see stance towards greenhouse gas reduction and climate change-related disclosure should seize the moment to step out of the sidelines. It is crucial for these organizations to comprehend their reporting and emissions obligations in light of the latest federal and provincial reduction plans. They must then formulate suitable compliance and remediation strategies to ensure their facilities align with the required standards. Making carbon emissions tracking a common practice is essential, particularly as banks, investors and suppliers increasingly demand disclosure of a company's scope 1 and scope 2 emissions. In many cases, this will likely involve reducing emissions profiles—and there is no better time to do so than the present. By 2025 or 2026, many of the government's cleaner energy projects will start coming online which means, right now, sourcing opportunities abound. Companies that seize this moment to invest in new energy projects and sources will not only benefit from lower pricing, but will also gain a leg up on their competitors. Additionally, buying low-carbon energy now may allow companies to acquire carbon credits early in the game—or become strategic investors in the space.

Things to think about

While today's proposed disclosure drafts focus primarily on publicly-listed companies, it is only a matter of time before these requirements trickle down to private companies. This will inevitably impact the expectations of debt and equity issuers.

To prepare, private companies would be well-served to outsource some of the work needed to track and reduce their carbon emissions and to implement a governance structure focused on reducing climate-related risk. Addressing climate change, along with its associated risks and opportunities, should become a recurring agenda item in board meetings as a matter of good governance.

As we move forward, companies will inevitably have to act aggressively to hit their mandated ESG targets, which may involve setting emissions reductions targets for senior executives. Additionally, governments have an increased interest in seeing how companies are including Indigenous communities in their energy projects. In several cases, the success of many climate change solutions and resource projects in Canada will depend on the involvement of Indigenous communities who are proximate to the projects.

Spotlight on: Labour and employment

Rob Weir & Benedict Wray

Skeletons out of the closet

Employment diversity, gender pay equity and sexual harassment are three workplace issues that have become more prevalent over the years—and with the ever-increasing focus on ESG, the spotlight shining on them is getting brighter.

We saw signs of this in 2022 as a growing number of organizations were forced to come to terms with how they dealt with historical claims of sexual harassment and abuse. Recent events indicate companies are now judged according to today's standards of transparency, openness and support for victims—even if a workplace incident took place 20 years ago.

People want to know how an organization handles these types of allegations, how perpetrators are treated once they are found to have violated policy, how victims are treated and whether there is financial transparency around human rights and employment law settlements.

Why it matters

While Human Resources departments are legally required to have human rights, harassment and violence policies in place, these policies are not typically part of the broader ESG conversation. Given how labour and employment matters are integral to the "S" in ESG, this is something that must change.

Evolving ESG regulations, legislation and frameworks are already nudging organizations in this direction. Investors and regulators are looking for organizations that have strong ESG and labour relations agendas—and frameworks like the UN Global Compact, the International Labour Organisation Conventions and Declarations, the International Bill of Human Rights and the OECD guidelines all outline expected employment standards.

In the UK, Australia and some US states (including California), gender pay gap reporting is now compulsory and neglecting to include these metrics in ESG reports can result in hefty fines. Similarly, all these countries have some form of supply chain transparency requirement relating to forced labour. Canada has now joined this trend with the passage of the *Fighting Against Forced Labour and Child Labour in Supply Chains Act*, which will come into force on January 1, 2024.

In short, it is almost impossible for organizations to meet the “S” in ESG without proactively making labour and employment part of their ESG strategy. Failure to do so in this environment could lead to reputational and legal ramifications down the road.

Things to think about

Now is the time for organizations to revisit their policies around harassment, gender pay, and diversity and inclusion and tie them to ESG.

For instance, you may want to:

- Integrate diversity and inclusion into your talent recruitment and retention efforts;
- Examine your remuneration structure and link it to ESG goals;
- Take steps to place employee welfare and D&I at the core of your procurement decisions; and
- Determine how ESG principles affect your workforce—including across the supply chain—and make an effort to anticipate and control associated risks.

From there, it may be wise to conduct a historical review of sexual harassment and abuse claims through this new ESG lens. This will help you proactively identify potential skeletons before they emerge.

Spotlight on: Governance

Fred Pletcher & Cameron MacDonald

An ESG-knowledgeable board

Last year, we saw a continuation of a trend that has been emerging for five years: a shift in responsibility surrounding ESG matters. It is no longer the VP Environment or General Counsel who bear the burden of ensuring compliance and who will be called to account if there is a lapse of ESG governance. With respect to the oversight of ESG matters, today, the buck stops at the board.

This is particularly notable because shareholder activism is on the rise—and shareholders of all stripes are expecting more on the ESG front. This has put pressure on boards to enhance their ESG stance, so in addition to having silos for finance, operations and risk management, now a growing number are building an ESG silo. Not only does this involve bringing in ESG experts to sit on the board (or at least inviting experts to the table from time to time), but there is a growing expectation that all members of the board have at least a broad understanding of ESG matters.

This is becoming increasingly important because of a second trend we are seeing—a transition toward more concrete ESG standards. While, in the past, companies could essentially choose which ESG standards and frameworks they would align themselves with, today ESG disclosures are becoming more codified and proposed regulatory changes in the United States and Canada are expected to provide additional guidance in the near future.

Why this matters

Trends in ESG are dictating additional requirements for boards and changing what constitutes adequate governance. First, because of the direction of ESG regulations and standards, empty ESG pledges are no longer sufficient. If a company says it is going to be Net Zero by 2050, shareholders will likely expect it to explain how it is going to get there. This will require greater specificity and more stringent approaches to measurement and ongoing disclosure.

Second, companies need robust ESG governance to proactively protect themselves. Investors have already shown themselves willing to remove directors from the board if they do not believe the company is taking appropriate ESG measures. Similarly, activist shareholders are using ESG as a wedge position to push a company in their desired direction.

Things to think about

In 2023, it is important for companies to be aware of a number of ESG governance trends, including:

- An increase in mandatory disclosure requirements particularly related to climate risk, diversity (including ethnicity, age, geography, disability, expertise, etc.) and forced labour;
- Heightened diversity expectations, including around board diversity. Companies that do not address shareholder expectations regarding board diversity appropriately may be subjected to diversity proposals moving forward;
- A bolder emphasis on ESG transparency—and more actions taken to prevent greenwashing; and
- Greater awareness of Indigenous concerns and an understanding of who your neighbours are, as well as a commitment to include local communities as potential business partners.

If a company is underperforming, it could become the target of activist investors. In this context, ESG could be used as a wedge with which activists seek to implement changes at a company. Best practices in governance involve considering and addressing these potential ESG issues before they become the subject of an activist campaign.

Spotlight on: Indigenous matters

Cherie Brant

Adding an ‘I’ to ESG

When ESG first came onto the scene, most companies focused primarily on the E—environment. Slowly, as the interconnection between the E and S became more visible, many organizational priorities shifted to give the “social” aspect more credence. In 2022, the horrific news surrounding Indigenous residential schools, combined with a five-year-old Reconciliation Report, heightened many organizations’ awareness around Indigenous issues.

Today, ESG-I strategies are becoming more commonplace as more boards make commitments to Indigenous reconciliation. Some companies are making a conscious effort to involve Indigenous communities in projects that might affect them, while others are setting Indigenous equity policies. More organizations are paying closer attention to how Indigenous people are reflected in diversity and inclusion efforts, with some looking for ways to move more Indigenous people into senior roles or partner with more Indigenous businesses.

Why it matters

ESG-I offers tremendous opportunities for organizations. Like everything ESG-related, Indigenous commitments need to have teeth. They must be grounded in the recognition that Indigenous groups possess constitutional rights—and genuinely strive to assist Indigenous communities in obtaining long-term sustainability by offering equity participation in projects and providing access to capital.

Not only are meaningful programs more inclined to positively impact share value, they also protect organizations from becoming subject to project delays or litigation.

Things to think about

Organizations considering an ESG-I strategy will have to scrutinize existing projects and business opportunities to make sure they truly align with proposed commitments.

For starters, this means weighing—and honouring—the preferences of Indigenous communities when supporting them. As an example, many companies offer jobs and training to Indigenous workers as part of their ESG-I commitments when many Indigenous communities would prefer access to capital or other supports that would allow them to become sustainable in their own right.

To achieve this, it is important to start viewing Indigenous businesses as potential partners. Rather than hiring contractors that employ Indigenous workers, for example, an effective ESG-I commitment may involve examining your existing supply chain, combing through your procurement policies, identifying relevant Indigenous businesses to partner with and seizing opportunities to support them.

Spotlight on: Tax

Laurie Goldbach

ESG and the fair tax movement

Over the last 10 years, companies in the public sector have faced growing pressure from investors and consumers to become better corporate citizens—and part of this involves paying their "fair share" of taxes. In response, we saw many companies shift their approach to tax planning in 2022, veering away from aggressive measures in favour of more transparent tax policy and governance.

ESG is naturally part of this new tax era. It is difficult to be a good corporate citizen in today's market without a strong ESG strategy—and tax policy is part of that. If you leave it out, there will inevitably be a disconnect, which can come back to haunt you later—either through reputational or legal ramifications.

Why it matters

In today's ESG environment, companies are operating under heightened tax scrutiny. Case in point: many of the recent ESG legislative changes, regulations and reporting requirements address tax reporting specifically. It is, therefore, important to consider:

- Many ESG standards, like the Global Reporting Initiative, include tax reporting components. For instance, the GRI 20 recommends companies "communicate and publicly disclose a tax policy which aligns to the company's overall ESG strategy."
- European legislation, such as the *2016 UK Finance Act* and Corporate Sustainability Reporting Directive (CSRD), require comprehensive voluntary disclosures across tax policy, governance and quantitative reporting.
- The World Economic Forum/International Business Council (WEF/IBC) updated its recommendations in 2020 to replace a country-by-country tax core metric with a total paid metric to better reflect a corporation's full contribution to public finances.
- The Base Erosion and Profit Sharing (BEPS) Action 12 in the Organization for Economic Co-operation and Development (OECD) report recommended expanding the mandatory disclosure rules to identify and respond to aggressive tax planning. Based on these recommendations, the Canadian government has introduced draft legislation on reportable and notifiable transactions—a series of tax rules that are ultimately designed to enhance disclosure rules to facilitate ESG transparency.

A strong tax governance model with an emphasis on transparency and reporting is not only a good defence against this increased scrutiny. In light of evolving regulations, it is also essential to future-proofing your business.

Things to think about

While ESG and tax "fairness" often go hand-in-hand, they can work against each other as well.

On the one hand, certain government policies and actions aimed at emissions reductions often offer various tax credits and incentives, which ultimately lower the taxes a company pays and its resultant tax impact. When their total tax drops, companies are criticized for not paying their fair share, resulting in a Catch-22.

One way to overcome this is to have a written, published tax policy—and make sure it is approved by the Board of Directors and linked to your organization's greater ESG mandates. This will allow you to pave a clear path forward and be able to make better tax decisions with the greater goal of ESG in mind.

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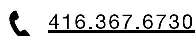

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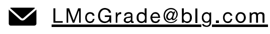
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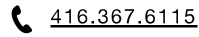
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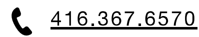
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