Semi-Annual ESG Sentiment Study of Canadian Institutional Investors

February 15th, 2023

Key observations

In December 2022, Millani conducted its Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, with 27 asset owners and managers representing over CA $6.1 trillion in asset under management.

Key observations include:

- **Perceived pushback in the US is not deterring investors from ESG.**
  Investors are not changing their Responsible Investment (RI) approaches, but they are clarifying communications of their strategies in response to market scrutiny.
- **Distinctions between sustainable outcomes and impact is growing.**
  Investors are moving from a bi-dimensional investment model (risk and return), to a tri-dimensional model (risk, return and sustainability). This transition may usher in the introduction of double materiality to the market.
- **Governance around supply chain and human rights is developing.**
  Canada is on the cusp of introducing legislation that will require Boards of Directors to report on how companies manage human rights within their supply chains.
- **Clarity on ESG and climate in executive compensation is needed.**
  Linking ESG and/or climate factors to executive compensation is an emerging trend – but investors need more clarity.
- **Biodiversity has risen to the forefront.**
  In this latest study, 48% of respondents rated it a top three focus area, compared to 18% in December 2021. Investors are discerning ways to adopt and integrate biodiversity assessment into their investment process.

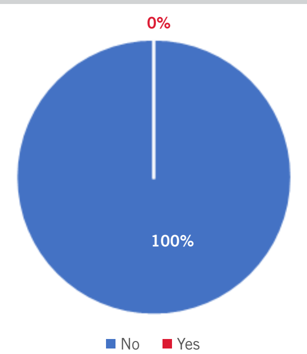
ESG pushback in the US is not changing investment approaches

The year 2022 was tumultuous, with the invasion of Ukraine by Russia, the rise in inflation, subsequent interest rates hikes, and negative stock and bond market performance. More broadly, we witnessed increased scrutiny of the capital markets and questions around ESG and if sustainable finance had plateaued.

Participants in this latest sentiment study were asked if the shifting environment had resulted in changes to their Responsible Investment strategies. All 27 firms responded that they had not changed their approaches to ESG integration (Figure 1), yet continual improvements were expected, as well as potential increased efforts towards engagement practices.

"ESG is part of our analysis, there is no change in our approach other than enhancing the ESG lens that we use. We're working on it and it's ongoing - it's evolving in a positive way." *– Asset Manager*

Figure 1
Are investors changing their approach to ESG integration?



In response to the increasing regulatory oversight around investment fund greenwashing, some participants mentioned that they are modernizing their integration of ESG, by adding parameters to clearly define their funds.

"On the one hand, we all agree on the necessity to consider ESG factors in decision making. On the other, from a legal and compliance perspective, we're more cautious. Nobody wants to be tomorrow's headline by promising one thing and delivering another." *– Asset Manager*

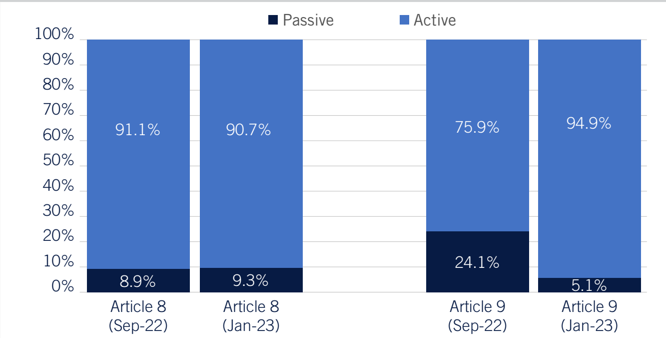
Some even suggested that the modernization of ESG integration draws parallels from the evolution of quantitative investing, which relies on statistical analysis and complex models to assess an investment vehicle's various technical investing factors (e.g. price, value, growth). As such, there may be more scrutiny on measuring, reporting and tracking ESG factor performance over time.

Throughout 2022, regulators tackled greenwashing by investigating claims of fraudulent advertising of sustainable funds. For instance, in May 2022, we saw German regulators raid DWS's offices,[1] leading fund companies, like Amundi,[2] to relabel their investment products a few months later. Amundi's funds' downgrades are not unique.

The increased scrutiny, and the European Sustainable Finance Disclosure Regulation (SFDR)'s Level 2 standards which came into effect in January 2023 - which has stricter alignment and requires increased disclosures - has led to a "wave of downgrades" according to Morningstar. Their report found that 307 funds reclassified themselves since September 2022 and more are expected in 2023.[3]

Figure 2 below shows how the reclassification of sizable index funds and ETFs tracking European Union (EU) climate benchmarks reduced the market share of Article 9 passive funds significantly from 24.1% in September 2022 to 5.1% in mid-January 2023.

Figure 2
Market Share of Active and Passive Funds Classified as Article 8 and Article 9



Source: Morningstar Direct. Assets as of Dec. 31, 2022. SFDR status as of Jan. 15, 2023, so January downgrades are accounted for. Based on SFDR data collected from prospectuses on 98.2% of funds available for sale in the EU, as well as January factsheets, KIDs, PRIIP KIDs, and fund company websites, excluding money market funds, funds of funds, and feeder funds.

Participants indicated that the increased ESG scrutiny coming from the SFDR, the labelling framework for investment strategies, is welcome. Many view this scrutiny as a sign of the markets maturing, and a strong indication that ESG topics are now being considered and integrated into investment analysis more broadly.

1. Fortune, Deutsche Bank raided by authorities over ESG 'greenwashing', May 31, 2022.
2. Bloomberg, Amundi, Deutsche Bank's DWS Downgrade ESG Funds in Big Reset, November 21, 2022.
3. Morningstar, SFDR Article 8 and Article 9 Funds: Q4 2022 in Review, January 26, 2023.

Some respondents indicated that part of the difficulty in fund classification is that ESG factors are now embedded across mainstream funds, as part of a best-in-class investing approach, making it difficult to classify ESG funds as a separate asset class. This was suggested as a potential explanation for why a recent Responsible Investment Association of Canada (RIA Canada) study indicated a plateauing of assets.[4]

In the US, various State Treasury Departments have been trying to limit the management of assets by firms using ESG labelling. These efforts have been referred to as polarizing and have been creating a disturbance for the asset management community. Our study participants indicated that despite these market dynamics, they are pressing forward with their ESG integration investment strategies.

Many participants mentioned increased interactions with their legal, compliance and communications teams. Ensuring investment policies align with communications is now deemed critical. It was expressed that proper communication of these approaches requires stringent internal reviews and continual education with clients on each firm's unique approach.

"This anti-ESG [movement] does not stop our ESG investing, but we do have a US presence so we are careful about how we are perceived. We want to evaluate misunderstandings or miscommunications about what ESG is and isn't. We are not into divesting, and the anti-ESG movement in the US is focused on stopping divestments." *– Asset Manager*

Respondents repeatedly called for regulators in Canada, the US and globally, to add clarity around product labels and terminology. The CFA Institute has been working to create appropriate terminology for the investment industry and there is anticipation that the Securities and Exchange Commission (SEC) will be providing guidance in the latter part of 2023.[5]

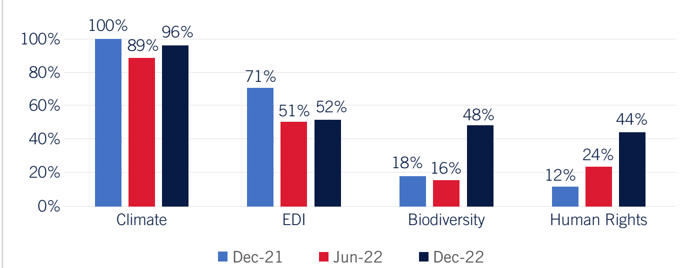
It was clear that as much as this perceived pushback is having a short-term impact, others are clearly looking to the next chapter. Looking at 2023 and beyond, some investors mentioned that the industry is moving from a two-dimensional model of risk and return, to a three-dimensional model of risk, return and sustainability.

"In 10 years, we should not be talking about this [ESG] anymore; we will attribute a monetary value to sustainability. Two-dimensional models of risk and returns will become three-dimensional, including sustainability. The companies we invest in will need to demonstrate that they rank high on sustainability factors to be a part of our portfolio." *– Asset Owner*

Top ESG focus areas

We asked respondents to share their top three ESG focus areas for 2023. Figure 3 shows the most cited topics compared to the responses from our December 2021 and June 2022 studies.[6,7]

Figure 3
Investors' top three ESG focus areas continue to evolve



Unsurprisingly, climate change remains top of mind for almost all respondents, with 96% indicating it is their top priority for the year ahead.

Equity, diversity and inclusion (EDI) was cited as a top focus area by 52% of investors, a smaller proportion than in December 2021. This may reflect that investors are shifting their focus from Board and management EDI to broader human capital management issues. In a year where talent attraction and retention has been challenging for many businesses, investors are now looking at topics like culture, training opportunities, employee engagement and well-being.

To note, when combining EDI and human rights (which includes Indigenous reconciliation), these topics are considered top focus areas by 78% of investors, which is not too far behind climate.

4. RIA, 2022 Canadian Responsible Investment Trends Report, November 2022.
5. CFA Institute, Global ESG Disclosure Standards for Investment Products, 2021.
6. Millani, Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, July 27, 2022.
7. Millani, Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, February 14, 2022.

This highlights the importance of the "S" in ESG and how the investor community continues to consider how to best evaluate these topics.

The most significant change in focus areas is related to biodiversity, cited by 48% of participants as a priority topic for 2023.

Climate change remains investors' number one preoccupation

Climate change remains top of mind for investors. After seeing two years of pledges and commitments by issuers, investors now expect to see actions and results. Investors want sincerity in issuers' transition plans and will assess capital expenditure plans, research and development, strategic adjustments, and continued demonstration of governance and oversight on the topic.

"We are trying to look under the hood for companies that have made commitments or adopted policies. What was news two years ago is no longer the case. We want to see capital expenditure plans, marketing spends, etc. Is what you are doing a marketing play, or are you looking to meet commitments made?" *– Asset Manager*

Respondents want to see transition plans and expect issuers to be ready to present and defend their plan, demonstrate progress, and engage. To support transition plans, investors are looking for clear targets and progression on targets already disclosed. Some investors cited that they want to see net zero science-based targets (SBT) aligned to the Paris Agreement.

"We want to see transition plans with actual proof points that are being enacted, such as capital allocations [...] We are looking for stringent targets, and I would love to see more focus on targets being met rather than targets being set." *– Asset Manager*

Some investors suggested that they will start to escalate their engagements by filing shareholder proposals. Although many of the investors indicated that they have refrained from using this tool as an engagement lever, they may no longer have a choice.

"Climate must move up the ranks. We may see more shareholder proposals coming on this topic. It's the only tool we have as asset managers to make a difference." *– Asset Manager*

The International Sustainability Standards Board's (ISSB) final climate disclosure standard, which is scheduled to be published in June 2023, is expected to require Scope 1, 2 and 3 disclosures, together with climate scenario analysis. Investors expect issuers to be preparing to adhere to these disclosure standards and to report on additional climate components such as packaging, shipping, and office buildings, to demonstrate robust reporting. In general, respondents indicated an eagerness for more regulatory frameworks to align with the ISSB's standards to enhance climate reporting and net zero transition plans.

"A lot of things are coming in 2023, how do we untangle all of it? It is a challenge to organize new norms and integrate them. In general, it's very positive to have so many requirements, like the ISSB. Montreal and Canada are well positioned, and there are opportunities for issuers to position themselves well." *– Asset Manager*

The ISSB currently has two proposed reporting standards: General Requirements for Disclosure of Sustainability-related Financial Information (S1) and Climate-related Disclosures (S2). In 2023, the ISSB plans to increase its focus on biodiversity and nature, human capital, and human rights.[8]

Biodiversity is scaling quickly

Despite the complexity of biodiversity, investors are eager to learn. Investors are focusing on understanding the intricacies of the topic and its related frameworks, such as the Task Force on Nature-Related Financial Disclosures (TNFD), and defining key performance indicators (KPIs) to integrate biodiversity issues into their investment analysis.

"We are doing some research on it [biodiversity] and we are having initial conversations with companies about it. Next year, we will be following up, and building some concrete asks." *– Asset Manager*

Akin to when climate reporting first started, gathering useful data remains one of the leading challenges around biodiversity for investors and corporates.

"Data and information transparency is still opaque right now. We are missing reliable and transparent data." *– Asset Owner*

8. IFRS, ISSB Update December 2022, December 2022.

A clear advantage biodiversity reporting may have over the initial uptake in climate reporting is the potential pace of adoption. The TNFD's proposed framework is based on the Task Force on Climate-Related Financial Disclosures (TCFD). In Millani's 6th Annual ESG Disclosure Study: A Canadian Perspective (2022), we saw adoption rates of the TCFD jump from 31% in 2021 to 45% in 2022 across the S&P/TSX Composite Index.[9] There is an expectation that the TNFD's adoption will be rapid as issuers and investors can leverage their understanding of the TCFD to implement the TNFD recommendations.

To prepare, issuers can familiarize themselves with the TNFD and consider how to prepare for Nature Action 100, a collaborative engagement initiative which was announced at the Kunming-Montreal COP15.[10]

The topic of biodiversity garnered increased attention in 2022, largely due to this latest edition of the COP meetings, wherein an agreement from many nations led to the formalisation of the "Kunming-Montreal Global Biodiversity Framework", setting out four goals and 23 targets to reach by 2030, including protecting 30% of lands and waters by 2030.[11]

Focusing on the "S": supply chains & human rights are the next frontiers

One topic that has been surfacing throughout our recent studies is supply chains and human rights. Many countries around the world have enacted modern slavery acts, including Australia, the United States, the United Kingdom, and Germany. Canada has yet to enact such legislation. However, Bill S-211, which is currently awaiting final approval and Royal Assent, may soon change this.[12] If the Bill is passed, it will require companies to file an annual "Supply Chain Risk Report" detailing how they aim to tackle and avoid human rights abuses within their supply chains. Notably, this report will need to be signed off by the Board of Directors of the organization.

Responses by investors were mixed but overall, human rights has seen a steady rise in materiality with 44% of investors indicating that it is a top four topic, up from 24% in June. Some investors stated no change in their focus, in some cases because they already attach a high priority to the topic, while others indicated a lack of internal resources. The firms who are increasing their focus suggested they are assessing human rights infringements locally, globally, and across sectors.

On a global basis, investors often consider Indigenous reconciliation as a human rights topic. However, within Canada, many investors consider Indigenous reconciliation to be a separate topic of high priority.

"We own, or co-own directly, or work with a manager that owns real assets. Some may run through Indigenous lands. We want to avoid unnecessary risk, and this is a component to manage. It's about having the social license to operate."
– Asset Owner

Investors clearly indicated that supply chain risks, human rights and Indigenous reconciliation are on their radar, and that they are specifically looking at potential risks related to controversies and reputation. Investors who are more advanced on this topic indicated that most companies need to do additional work and start disclosing information about their practices.

"There's some momentum in certain sectors. Some [companies] are really trying to be more transparent about who their suppliers are, conflict regions, governance, and remedy processes in place for human rights, beyond their employees. We're starting to see some sectors react sooner than others with more benchmarks and frameworks. It's no longer nascent, but not yet mature."
– Asset Manager

Other respondents indicated that companies would not disclose their risks related to human rights, therefore it is up to investors to carry out thorough due diligence and subsequent engagements.

"You can never expect a company to come out and say that they have a [supply chain human rights] risk. It's not about reporting on the type of risk. It's about making it understood through more engagement [that it matters to you], helping in addressing it and taking action."
– Asset Owner

9. Millani, Millani's 6th Annual ESG Disclosure Study: A Canadian Perspective, September 2022.
10. Nature Action 100, At COP15, investors announce Nature Action 100 to tackle nature loss and biodiversity decline, December 2022.
11. Official CBD Press Release, Nations adopt four goals, 23 targets for 2030 in landmark UN biodiversity agreement, December 19, 2022.
12. Parliament of Canada, S-211 An Act to enact the Fighting Against Forced Labour and Child Labour in Supply Chains Act and to amend the Customs Tariff, November 30, 2022.

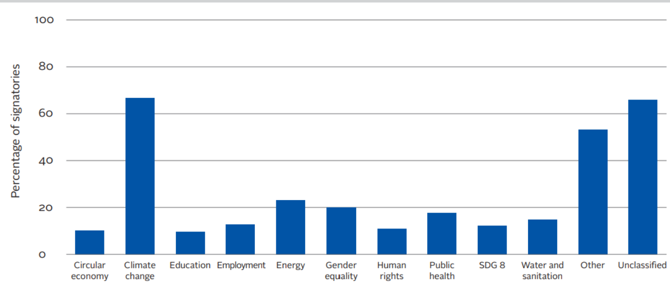
Impact investing or sustainable outcomes?

Increasingly, clients, beneficiaries, policy makers and other stakeholders are requiring investors to align their investment and stewardship activities with broader societal objectives, such as the UN Sustainable Development Goals (SDGs), the Paris Agreement and the International Bill of Human Rights. These are increasingly being considered the "sustainable outcomes" of investing. In the 2021 UN PRI reporting cycle, signatories were asked to report on how they integrate sustainability outcomes into their investment approaches. In December 2022, the UN PRI reported: "*Of the 2,796 investment manager and asset owner signatories that reported, two-thirds identified one or more positive or negative sustainability outcome connected to their investment activities. However, only 33% said they have proactively taken action to increase or decrease these outcomes [...] Signatories that reported taking action on sustainability outcomes did so primarily in relation to climate change. Of the 945 signatories that had not yet identified sustainability outcomes, half were intending to do so in the future.*"[13]

The graph below (Figure 4) is an excerpt from the report showing the percentage of signatories reporting outcomes per category:

Figure 4

Percentage of signatories reporting outcomes per category



Source : UNPRI, Sustainability Outcomes: What Does Our Reporting Data Reveal About Emerging Signatory Practices? December 2022

These reporting efforts by investors are expected to increase as they consider broader environmental and societal topics in their investment assessments, stewardship practices, and engagements.

In July 2021, Freshfields Bruckhaus Deringer published "A Legal Framework for Impact" seeking to understand the fiduciary implications for investors related to this move towards sustainable outcomes.[14] It was mentioned that asset owners, where they feel there may be an implication on the overall financial system from disruptions caused by environmental or social issues, may have a duty to consider these elements in their investment approach.

This shift may be the driver towards the tri-dimensional model of risk, reward, and sustainability.

Study respondents recognize that this shift is growing and understand that their primary obligations are to beneficiaries. Therefore, they are considering how to measure these outcomes and are careful not to label their efforts as impact investing.

"We need to do more on outcome measurement – we don't say impact because of the connotation to charity. We are equipping ourselves, while being careful. ESG backlash is due in part to the careless plastering of SDGs all over the place. We need to be more intelligent about [how we report] it."
– Asset Owner

This is an indication of some of the headwinds we observed with regards to impact investing in the institutional market. It was expressed that impact funds need to have intentionality and demonstrable and measurable results. We heard that as the impact sector is developing, part of the challenge is about scalability.

"It's hard to construct a product in the public market and convince investors that you are making an impact and that you are accountable. There are better opportunities to be "on the ground" with private markets, albeit the opportunities are smaller than for public markets." *– Asset Manager*

We are, nonetheless, seeing an increase in impact funds being developed in the market. However, investors identified that the issue of vague labelling and lack of regulations has been leading to inconsistencies in the impact market, with a strong call for Canadian regulators to advance on this topic.

"There is a major labelling and terminology problem. Language matters. A lot of Canadian definitions are not consistent with global definition [...] The CSA still has no detail on fund types." *– Asset Manager*

Respondents also indicated that there remains a need to clarify investors' fiduciary duties. Many expressed that the SFDR labelling requirements for Article 8 or 9 funds should assist in clarifying the differences.[15]

13. PRI, Sustainability Outcomes: What Does Our Reporting Data Reveal About Emerging Signatory Practices?, December 2022.
14. Freshfields Bruckhaus Deringer, A Legal Framework For Impact, July 2021.
15. Official Journal of the European Union, Regulation (Eu) 2019/2088 Of The European Parliament And Of The Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, November 2019.

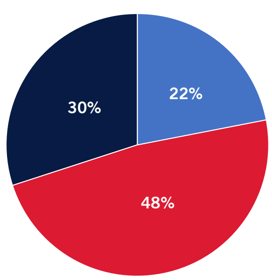
Impact is long-term focused, not a box-checking exercise. It requires dialogue between investors and issuers. As investors increase their efforts on demonstrating the impacts of their investments, issuers may be tempted to align themselves to certain SDGs – without intentionality. This could be a challenge moving forward and could lead to claims of "impact-washing".

This is where the discussion of double materiality comes into play. Other markets, namely Europe, are advancing on their application of this concept, yet North America seems to be lagging. Given capital flows on a global basis, leading issuers have already begun assessing double materiality, and we anticipate further uptake in 2023. In the short-term, issuers can consider the intentionality behind the alignment to the SDGs, and establish clear processes to set targets and monitor progress over time.

Where's the money?: ESG-linked compensation is coming to the forefront

Our study showed that 70% of respondents indicated that they are either already engaging on ESG- or climate-linked compensation, or actively consider it in their investment analysis (Figure 5).

Figure 5
Investors and ESG-linked compensation



Most recognized that the topic is complex. However, expectations are increasing. Investors want clarity on the level and structure of compensation, and clarity around the relevance and weight of KPIs being used. Some are willing to use their proxy voting powers or join collaborative engagements, like the Canadian Coalition for Good Governance (CCGG), to enact change.

"We are not voting against the Board yet on ESG-related compensation. We are voting against a Director if their compensation is outsized or not transparent relative to other goals of the company. We're not using shareholder resolutions or votes against management on compensation yet."
– Asset Manager

Millani's 6th Annual ESG Disclosure Study found that 47% of issuers have some kind of ESG-linked executive compensation, and that 27% had climate-linked executive compensation.[16] Given this, and the forthcoming ISSB recommendations on climate disclosures which are expected to have executive compensation linked to targets and plans, issuers may want to give serious consideration to these plans and prepare for further discussions with their investors.

16. Millani, Millani's 6th Annual ESG Disclosure Study: A Canadian Perspective, September 2022.

Calls to action

- Investors need to remain cautious in how they communicate their ESG practices, as regulator and public scrutiny increases. Internal audits of ESG processes, policies and examination of external managers may be required to protect against accusations of greenwashing, not fulfilling one's fiduciary duty or being caught up in ESG pushback.
- Climate change remains at the top of investors' concerns.
- Interest in biodiversity is quickly scaling. Investors and issuers can educate themselves on the topic and how to identify and assess its risks.
- If Bill S-211 is passed in Canada, Boards of Directors will be required to sign off on forced and child labour risks in an organization's supply chain. Investors are well advanced on this topic and will be assessing issuers' reactions. Issuers are advised to be preparing for increased and swift engagement.
- As investors move towards sustainable outcomes and impact, issuers should give serious consideration to their reporting claims relating to their impacts on the SDGs. The creation of internal processes for measurement of intentional impact will be key.
- Regulators are being asked to clarify definitions for labelling of ESG and impact-oriented products to reduce market confusion. Clarity of investors' fiduciary duty as they move towards sustainable outcomes will also be welcomed.
- ESG- or climate-linked compensation is expected be the next top governance issue. Issuers should give serious consideration to how they are creating and setting their executive compensation plans.

Contributors

Thank you to our contributors who took the time to provide their insights on key ESG trends. Our contributors represent 27 of Canada's largest institutional investors, some of which are listed below.

About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 15 years, Millani has become the partner of choice for institutional investors. By providing advisory services on developing strategic ESG communications, engagement and disclosure strategies and integrating material ESG issues into their investment strategies and decision-making processes, we help our clients reduce risks, increase returns, and create value. Millani is also leveraging this expertise and its experience in ESG consulting to help reporting issuers improve their ESG disclosure and engagement strategies to optimize their market value.

For more information, contact us at info@millani.ca or visit our website: www.millani.ca.