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TAKING STOCK OF GOVERNANCE — UNDERSTANDING EMERGING ESG, REGULATORY, AND MARKET TRENDS (ADAPTED TO THE PROVINCE OF QUÉBEC)

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The COVID-19 pandemic and increased concerns over environmental and social issues, such as climate change, biodiversity, water pollution and systemic racism, have prompted conversations throughout various levels of global capital markets. Within Canada, recent trends have included an increased focus on sustainability, diversity, and the need to promote resiliency and corporate purpose.

These factors are complicating board decision-making, challenging the shareholder-centric model of governance that has guided boards for the past several decades, towards a more stakeholder-centric model, and raising expectations of independent directors who oversee corporations. This bulletin summarizes key corporate governance developments.

1. Legislative Amendments

CBCA Amendments

In May 2018, certain amendments to the *Canada Business Corporations Act* (“**CBCA**”) were passed that would:

- **Election of Directors**. Require certain CBCA corporations to require that separate votes be held (i.e., would prohibit slate voting) for the election of each candidate to the board of directors;
- **Majority Voting**. Require public companies to implement a majority-voting requirement where such elections are uncontested (i.e., where there is only one nominee for each available board seat). The amendments will effectively supersede TSX majority voting policies by statutorily providing that a candidate without majority support has not been elected, thereby precluding the need for them to resign; and
- **Individual Director Voting**. Permit shareholders to vote shares for or against (rather than “withholding” shares from voting) each nominee in uncontested director elections.

The proposed regulations to implement the above-mentioned CBCA amendments were initially scheduled to come into effect on July 1, 2021 but have since been delayed to minimize disruptions during this year’s proxy

season. A new date has not been confirmed. Given that a number of corporations have a fiscal year-end that overlaps with the calendar year-end, it is likely that the regulations will be earmarked for next year's annual meetings.

BCBCA Amendments

In British Columbia, Bill 9 – *2021: Finance Statutes Amendment Act (No. 2), 2021* received first reading in the legislature on May 12, 2021. Among other things, the bill proposes amendments to Business Corporations Act (British Columbia) ("**BCBCA**") to facilitate virtual meetings of shareholders and directors. In particular, the bill provides that:

- **Voting Instructions**. For electronic meetings, the notice of meeting must contain instructions for attending and participating in the meeting by telephone or other communications medium, including, if applicable, instructions for voting at the meeting.
- **Participation of Shareholders**. Clarifies that if a company holds a meeting of shareholders that is an electronic meeting, the company must permit and facilitate participation in the meeting by telephone or other communications medium.

2. Autorité des marchés financiers 2021-2025 Strategic Plan

Earlier this month, Québec's *Autorité des marchés financiers* ("**AMF**") published its 2021-2025 Strategic Plan and identified risks associated with climate change, the use of sustainable finance and the greater reliance of portfolio managers on ESG investing criteria primary issues to focus on during the next four years. More particularly, staff of the AMF will pay attention to the effect of climate change on insurer and certain other industries (agriculture, resources and financial, among others), the various framework adopted to regulate sustainable investments products and assets class and risk to investors associated with greenwashing which occurs when there exists a disconnect between the attribute given to a so-called "green" investment product and its actual performance in terms of sustainability or GHG emission reduction impact. One of the objective stated by the AMF in its Strategic Plan is to continue to position itself proactively with respect to the legislative framework and the disclosure rules proposed for ESG factors. Many believes that policing of such disclosure rules is an essential step that will soon be required in order to provide confidence to market participants in their effective understanding of the climate related risks and opportunities of a particular issuer and management's responses and board's oversight of such risks and opportunities. The AMF is simply echoing the fact that the ESG information disclosure environment has not kept pace with the exponential growth recently seen in ESG-related financial products.

3. Recommendations of Ontario's Capital Markets Modernization Taskforce

In January 2021, Ontario's Capital Markets Modernization Taskforce (the "**Taskforce**") released its final report, which included substantive recommendations aimed at overhauling Ontario's securities regulation regime. The Taskforce's objectives included promoting growth and competition in Ontario's capital markets system, as well as enhancing enforcement powers to protect investors. The final report covered a broad range of issues, including corporate governance matters as follows:

- **Mandatory Adoption of Diversity Targets, Timelines, and Director Implementation Policies**. All reporting issuers must set board and executive management diversity targets and timelines to increase the representation of self-identifying women, black, Indigenous and persons-of-colour ("**BIPOC**"), disabled, and LGBTQ+ persons. Issuers should also provide annual data on the progress made under these targets and timelines. The Taskforce also recommended that issuers have a written policy on director nominations, which expressly addresses the identification of candidates who self-identify as women, BIPOC, disabled, and LGBTQ+.
- **Maximum Board Term Limits**. In order to increase board diversity, the Taskforce recommended a maximum board term of 12 years for directors of publicly listed issuers, with exceptions for: (i) the chair of the board (15 years), (ii) non-independent directors of family-owned businesses, where such nominees represent a minority of the board, and (iii) no more than one other director who will be deemed not to be independent.
- **Universal Proxy Ballots and Mandatory Voting Disclosure**. All contested shareholder meetings should use universal proxy ballots (i.e., a single ballot listing all director nominees on each side of a dispute). Mandatory disclosure of voting tallies on an ongoing basis would also be required in contested meetings for greater transparency.
- **Mandatory Independent Committees in Conflicts of Interest**. Reporting issuers be required to adopt written policies to guide mandatory independent committees, which should oversee all material conflict-of-interest transactions. This recommendation came alongside a larger call for the codification of commentary on Multilateral Instrument 61-101 – *Protection of Minority Security Holders in Special Transactions*.
- **Early Warning Disclosure**. The Taskforce recommends decreasing the shareholder reporting threshold from 10% to 5% for non-passive investors. Disclosure would be required if an investor intends to make a take-over bid, proposes a transaction that would result in the investor gaining control of an issuer, or solicits proxies against any director nominees or corporate actions proposed by the management of an issuer.
- **Director Elections and Voting Requirements**. All uncontested director elections should be subject to majority voting policies and be codified in Ontario's securities laws for greater shareholder democracy.
- **Enhanced ESG Disclosure**. Mandatory disclosure of material environmental, social, and governance

("**ESG**") information that is compliant with the recommendations of the Taskforce on Climate-Related Financial Disclosure ("**TCFD**"), an international body established by G20 leaders, on a "comply or explain" basis. The proposed requirements, which would apply to all reporting issuers (except for non-investment funds) are:

- Mandatory disclosure recommended by the TCFD related to governance, strategy, and risk management (subject to materiality), excluding mandatory disclosure of scenario analysis under an issuer's strategy; and
- Disclosure of Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas emissions on a "comply-or-explain" basis.

Given the concerns that immediate mandatory reporting could burden venture issuers, the Taskforce recommended the use of a market capitalization-based test to phase in ESG reporting, accompanied by a transition phase that provides time to issuers to comply with the new requirements. The duration of each issuer's transition phase would depend on its market capitalization at the time the requirements are implemented as follows:

- Large issuers (greater than $500 million) – transition phase of two years;
- Medium issuers (between $150 million and $500 million) – transition phase of three years; and
- Small issuers (less than $150 million) – transition phase of five years.

On March 24, 2021, the 2021 Ontario government released the provincial budget in which it announced that it was proceeding with certain recommendations of the Taskforce, including expansion of the mandate of the Ontario Securities Commission ("**OSC**") to include competition and capital formation. The government also noted that in the coming months, it would publish the draft Capital Markets Act for stakeholder consultation. Concurrently, the OSC is conducting analysis to inform its regulatory consultation process on the Taskforce's recommendations that fall within its rules.

4. Institutional Shareholder Services Inc. and Glass Lewis & Co. Guidelines

The rise of passive investing has increased the influence of proxy advisory firms such as Institutional Shareholder Services Inc. ("**ISS**") and Glass Lewis & Co. ("**Glass Lewis**"). These firms control an estimated 97% of the US market share and exert considerable influence on corporate governance trends. For the 2021 and 2022 proxy seasons, both ISS and Glass Lewis made notable changes to their proxy voting guidelines.

- **Gender Diversity**. For S&P/TSX Composite Index issuers, ISS recommends that shareholders withhold their votes from the committee chair responsible for board nominations if the board is comprised of less than 30% women directors, and (i) the company has not disclosed a formal written gender diversity

policy; or (ii) the company's formal written gender diversity policy does not have a commitment to achieve at least 30% women on the board in a reasonable timeframe. Such policies must evidence a clear commitment to increase board gender diversity; boilerplate language may result in a recommendation to withhold. This recommendation will be in force as of February 2022 but will not apply to newly listed public companies or companies recently graduating from TSX-V, or companies with fewer than four directors.

Similarly, in 2021, Glass Lewis started noting boards with fewer than two female directors as a concern. Beginning on January 1, 2022, Glass Lewis will generally recommend voting against a nominating committee chair with fewer than two female directors. This policy does not apply if there are six or fewer board members, in which case at least one board member must be a woman. In both 2021 and 2022, Glass Lewis may refrain from making a negative recommendation if the board provides a sufficient rationale or a plan to address the lack of board diversity.

- **Audit Committees**. Glass Lewis has revised its recommendations such that at least one member of an audit committee should have experience as a certified public accountant, CFO or corporate controller, or have demonstrable meaningful experience with regard to financial literacy. This standard is stricter than the "financial literacy" definition under National Instrument 52-110 – *Audit Committees*, bringing Glass Lewis' recommendations closer to the U.S. Securities and Exchange Commission (the "**SEC**") for "audit committee financial experts". Glass Lewis will now flag any such shortfalls in professional experience as a concern in its reports, but, for 2021, will generally refrain from making recommendations solely on this basis, absent other concerns regarding the issuer's audit committee.
- **Board Refreshment**. To foster diversity and innovation, Glass Lewis updated its recommendations to note, as a concern, instances where non-executive directors have an average tenure of ten or more years and where no new independent directors have joined the board in the last five years. This will not automatically result in a negative recommendation; however, insufficient board refreshment will be considered in Glass Lewis' recommendations where additional board-related concerns are identified.
- **ESG Disclosure**. On January 1, 2022, Glass Lewis will begin recommending that shareholders vote against governance chairs in S&P/TSX 60 index companies that do not explicitly disclose the board's role in overseeing environmental and social issues (currently, Glass Lewis is only noting such failure to disclose as a concern). Glass Lewis will also recommend voting against board members who are responsible for the company's failure to properly manage or mitigate environmental and social risks that are detrimental to, or threaten, shareholder value.

Currently, ISS does not have comparable requirements with regard to environmental and social risks. However, ISS will recommend that shareholders withhold votes for directors, or the entire board, in instances where a

director or board has made a material failure in risk oversight, including for environmental and social issues.

- **Board Skills**. Glass Lewis may now recommend that shareholders "withhold" their votes from the election of the chair of the nominating committee if a board has not addressed major issues of board composition, including the composition, mix of skills, and experience of the non-executive element of the board.

5. The Kaplan-Dey Report

In February 2021, Peter Dey, an executive-in-residence at the Rotman School of Management, and Sarah Kaplan, a professor of strategic management at the Rotman School, published a report entitled "360° Governance. Where are the Directors in a World in Crisis?" (the "**Kaplan-Dey Report**"). Their report was a follow up to the 1994 Dey Report, which is seen as instigating several corporate governance reforms in Canada.

The Kaplan-Dey Report offers guidelines to address societal concerns, such as systemic racism, COVID-19, climate change, and economic inequality. It provides 13 corporate governance guidelines for boards of directors to prepare them for upcoming regulations, increased investor expectations, and material impacts of stakeholder issues as follows:

- **Corporate Purpose**. Identify, disclose, and regularly review the purpose of the corporation's business.
- **Board's Duty**. Understand that it must act with a view to the corporation's best interests.
- **Definition of Stakeholders**. Have knowledge of the corporation's stakeholders.
- **Rights of Indigenous Peoples**. Establish and implement a mechanism for fostering its relationship with Indigenous peoples.
- **Reporting on Stakeholder Impact**. Integrate reporting on stakeholder impact in its annual report, including integrated sustainability and social responsibility reporting.
- **Formation of a Stakeholder Committee**. Create a stakeholder committee to identify stakeholders that have a material impact on the corporation's business over the long term and establish mechanisms for engaging directly with key stakeholder groups.
- **Addressing Stakeholder Conflicts**. Use processes that fairly consider all stakeholder interests in resolving stakeholder conflicts to ensure that no stakeholder's interests were unfairly disregarded in making a board decision.
- **Executive Compensation Policies**. Ensure that management compensation is aligned with achieving the purposes and long-term sustainability of the company.
- **Board Refreshment**. Have a process that ensures board renewal, board diversity, and the right mix of skills across the skills matrix.
- **Board Diversity**. Represent the communities in which the corporation operates, which includes

announcing diversity targets for female board representation and tracking progress on such targets.

- **Organizational Diversity**. Have and disclose a policy on leadership and work force diversity in terms of all Human Rights Code diversity dimensions.
- **Climate Change**. Have and disclose a policy for addressing climate change and climate-related risks and opportunities, including disclosure of its processes for considering climate-related issues.
- **Corporate Activism**. Have the CEO lead decision-making processes on issuing statements related to corporate activism, both in the face of societal pressures and of its own volition.

6. TSM Climate Change Protocol

On May 5, 2021, the Mining Association of Canada ("**MAC**") released a new "Climate Change Protocol" ("**CCP**") for its Towards Sustainable Mining ("**TSM**") performance standards to respond to emerging investor expectations around climate-related disclosures. The new CCP complements seven other TSM protocols that cover: (i) safety and health, (ii) community and indigenous peoples engagement, (iii) crisis management and communication, (iv) prevention of child and forced labor, (v) tailings management, (vi) water management, and (vii) biodiversity conservation management.

The CCP criteria, which were developed in part from the TCFD recommendations, require mining companies to disclose their strategy, scenario planning, and risk-assessment models for:

- Board and management structures and reporting processes related to the governance of climate-related risks and opportunities.
- A corporate climate change strategy supported by actions and integrated into business planning.
- Analysis and management of material climate-related risks and their impacts on the company's broader business, strategy, and financial planning.
- Reporting of materials on corporate governance, strategy, risk analysis, metrics, and targets related to climate action.

As 75% of Canada's minerals and metals production is represented by MAC's membership, TSM is expected to increase expectations of how mining companies in Canada report on their plans for handling both the physical and financial challenges posed by climate change.

7. Developments in the United States and with the SEC

President Biden's campgain promised a comprehensive climate plan, which included a requirement for "public companies to disclose climate risks and the greenhouse gas emissions in their operations and supply chains." Anticipated changes to the SEC's regulatory regime that address these campaign priorities include:

- **Enhanced ESG Disclosure**. In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement. The initial focus of the task force will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force is also expected to evaluate and pursue tips, referrals, and whistleblower complaints on ESG-related issues, and provide expertise to teams working on ESG-related matters across the Division.

Following the announcement of the task force on March 15, 2021, acting SEC Chair Herren Lee also issued a public statement instructing the SEC staff to evaluate existing "disclosure rules with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change."

On May 2020, 2021, President Biden issued an executive order that directs Janet Yellen, Treasury Secretary and head of the Financial Stability Oversight Council, to issue a report on "climate-related financial risk data". This order also directs the Office of Management and Budget and the Council of Economic Advisers to "publish an assessment of the government's climate risk exposure."

- **Human Capital Disclosure**. Effective November 9, 2020, the SEC issued final rules amending the requirements of Regulation S-K. One amendment to Item 101(c) of the rule includes "a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business". The new human capital disclosure rule takes a principles-based approach, which means there is no predetermined definition of the term "human capital." The SEC is leaving it to the issuers to decide how to define human capital in terms that are "material" to them. As a result, in certain SEC filings, a public company is now required to disclose:
  - the number of employees and a description of its human capital resources, if material to the business as a whole; and if material to a particular segment, that segment should be identified; and
  - any human capital measures or objectives, if material, that the registrant focuses on in managing its business, such as those related to the development, attraction, safety, engagement, and retention of employees.

Willis Towers Watson ("**WTW**"), a global human resources consulting firm, reviewed the first three dozen human capital disclosures by companies in the S&P 500 published in 10-Ks and found that most companies included the descriptions "employee development and training" and "diversity initiatives and strategies." WTW review also found that each disclosure also included at least one human capital metric with the total number of employees disclosed being most prevalent.

Learn about new developments in sustainability and how McMillan LLP can help you reach your ESG goals here.

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A Cautionary Note

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