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MY PORTFOLIO IS GOING TO POT: ESG RISKS RELATED TO INVESTMENT IN RECREATIONAL CANNABIS

ESG | Insights

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KEY TAKEAWAYS

- The momentum achieved to date in the legalization of recreational cannabis use looks to have taken a hit in the recent New Zealand referendum.
- Asset owners and managers should consider their exposure to the cannabis industry – given the rapid growth of the sector, many small cap and venture capital funds may be exposed.
- When looking at the cannabis industry, there is considerably more to the "medical" label than meets the eye – investors need to be clear about their comfort levels around recreational cannabis use.
- As the cannabis sector grows globally, investors need to ensure that their responsible investment frameworks take the related issues into consideration, and they have access to appropriate data sources to help identify corporate involvement.

INTRODUCTION

The recreational use of cannabis has been legalized in two major global markets - Canada and numerous U.S. states - with serious implications for responsible investors. New Zealand also held a referendum on the legalization and control of recreational cannabis during the October 2020 federal election. Preliminary results released October 29 indicate that New Zealanders have voted against the legalization of recreational cannabis use. The final results are due for release on November 6.

Asset owners and managers will need to develop policies to manage the environmental, social and governance (ESG) risks associated with this emerging industry.

Asset owners in particular need to start preparing to answer three key questions:

- Is there pot in my portfolio?
- Should I care?
- What can I do about it?

ISS ESG has recently worked with a client to develop one of the world's first broad datasets seeking to capture all companies within the global supply chain for cannabis. Rather than simply listing companies with an association with cannabis, ISS ESG has drilled down into each company's activities to ascertain the nature of their involvement, including distinguishing between genuine medicinal versus recreational products and services.

How are asset owners and managers likely to be exposed to the cannabis industry and how can the risk of exposure be addressed? ISS ESG predicts that a regulated recreational cannabis industry is likely to evolve into something akin to the current tobacco and alcohol industries, with a number of familiar ethical issues.

IS THERE POT IN MY PORTFOLIO?

The rapid growth of the cannabis market and its presence on stock markets around the world means that asset owners in particular are likely to already have at least some portfolio exposure to cannabis. Asset owners invested in alternative asset classes can be exposed through either venture and/or micro venture capital. Venture capitalists seeking high growth and increased portfolio performance have been the first into the cannabis market, particularly as legislation continues to be passed internationally to legalize parts of the industry.

Global asset managers should also consider whether they are exposed to the cannabis sector indirectly. Large companies in unrelated industries are already dipping their toes in the water. For instance, Constellation Brands - a multinational alcohol company and owner of Corona beer - has made three separate equity investments in Canadian cannabis giant Canopy Growth, bringing its current total shareholding to 38.6%.

In addition to growth in the industry, two other factors influence whether or not an investor should consider the presence of cannabis in their portfolio: local geographical regulations; and uncertainty around terminology used by the industry, especially regarding the term "medical cannabis."

CANNABIS LEGISLATION AND REGULATION AROUND THE WORLD

Currently, three UN treaties govern the use of cannabis. The most salient of these to the recreational cannabis industry is the 1961 Single Convention on Narcotic Drugs, which "seeks to limit the possession, use, trade in, distribution, import, export, manufacture and production of drugs exclusively to medical and scientific purposes." Signatories to the Single Convention are compelled to implement legislative measures prohibiting the production, use and trade of narcotic drugs.

This convention classifies substances under four schedules, designated according to potential for abuse and potential therapeutic value. The schedules determine the extent of restrictions on international trade for medical and scientific purposes. Schedule I designates "substances with addictive properties which present a serious risk of abuse." Such substances are subjected to the most rigorous controls under the convention. The Schedule IV classification applies to "the most dangerous substances, already listed in Schedule I, which are particularly harmful and of extremely limited medical or therapeutical value." Cannabis is listed under both Schedules I and IV, alongside heroin. As such, its use even for medical and scientific purposes is significantly restricted.

Further, its classification under the Single Convention significantly hinders the possibility of trading cannabis for medical purposes. However, it is worth noting that in January 2019, the World Health Organization Expert Committee on Drug Dependence re-examined the classification of cannabis for

the first time since its scheduling by the League of Nations in 1935. This examination resulted in the committee recommending that cannabis be removed from Schedule IV (to remain in Schedule I) on the basis of its potential therapeutic value. The UN Commission on Narcotic Drugs, whose prerogative it is to implement these recommendations, has not done so.

The International Narcotics Control Board is tasked with overseeing compliance with these conventions. In 2018, Canada became the second country (the first being Uruguay) to legalize the possession, cultivation and sale of recreational cannabis - in direct contravention of UN treaties. In response, the board released a statement strongly condemning the move and expressing concern for public health; no further outcomes are yet apparent.

Recreational cannabis remains illegal at the federal level in the U.S. Despite this, 12 states (including Washington, D.C.) have now legalized its use at the local level. "Medical" cannabis is legal in 33 states and Washington, D.C, with California and Colorado as key players in the industry. There are a significant number of cannabis companies listed on U.S. stock markets, with the cannabis market experiencing exponential growth in recent years. Growth is expected to continue; the industry is booming, despite the legal grey area in which companies operate.

In the EU, all member countries regard the supply and possession of marijuana for recreational use as an offence, although the approach to penalties varies from state to state. The Netherlands has for many years deliberately (and famously) turned a blind eye to the sale of marijuana at coffee shops in specific cities. The Portuguese approach of decriminalizing a range of drugs, coupled with strong investment in diversion and addiction treatment programs, has attracted a lot of interest from other regulators in recent years. To date, however, no European state has gone down the road of full legalization.

In Australia, the focus has been on the clearly defined production of medicinal cannabis, as set out by the Australian government's Office of Drug Control. A licence enables the lawful cultivation of cannabis, and the permit specifies the amount, type and timeframe of crop production. In January 2018, the Australian government announced that it would allow medicinal cannabis products to be legally exported.

The ASX has a growing number of companies involved in the production of cannabis, the largest (by market cap) currently being Ecofibre (EOF), Cann Group (CAN), and Althea Group (AGH). Legislation relating to the consumption of marijuana for recreational purposes is the purview of state governments. South Australia has decriminalized minor drug offences, while the Australian Capital Territory has decriminalized personal use. The production and use of cannabis for recreational purposes remains a criminal activity in all other states and territories.

Neighboring New Zealand has also put in place legislation governing the medicinal use of cannabis. In 2019, the Misuse of Drugs (Medical Cannabis) Regulations were introduced, facilitating the establishment of a national Medical Cannabis Scheme. Under the scheme, access to medical cannabis is now legal (contingent upon a prescription), as are the research, manufacture, cultivation and supply of medicinal cannabis products and related ingredients. A referendum on the legalization and control of recreational cannabis was also held in October 2020. Preliminary results released October 29 indicate that New Zealanders have voted no on this proposal. The final results are due for release on November 6.

There are at least 10 companies already active in New Zealand's cannabis market. Most emerged in anticipation of the Medicinal Cannabis Scheme, and several are still in the early days of establishing operations and securing appropriate licensing. All New Zealand-based companies are, as currently

required by law, purely medicinal - though some were expected to move into the recreational business had the referendum seen a "yes" result. Cannasouth Limited is currently the only listed New Zealand cannabis company, with Rua Bioscience planning to go public by the end of this year.

MEDICAL VERSUS RECREATIONAL CANNABIS

There are at least 144 naturally occurring compounds called cannabinoids present in cannabis. Two of these are known to interact with cannabinoid receptors in the human body in quite specific ways. The first is THC (delta-9-tatrahydrocannabinol), which is the psychoactive cannabinoid - responsible for producing the well-known "high." Cannabidiol (CBD), on the other hand, is not psychoactive, and is associated with a lower risk of adverse effects. Both THC and CBD have therapeutic properties, and genuinely medical products may contain either one or both.

There are a huge number of unsubstantiated claims relating to the medical benefits of cannabis. As noted by a 2018 study examining the state of evidence-based medical cannabis use, "although the evidence for the safety and effectiveness of the different cannabinoid compounds is scarce, claims of the miracle effects are plenty." In the U.S., the Food and Drug Administration is cracking down on such claims, particularly related to the growing list of purported applications of CBD.

There is some medical evidence to support the following applications of cannabis and cannabinoids (in decreasing order of certainty): chronic pain, nausea and vomiting due to chemotherapy, spasticity due to multiple sclerosis or paraplegia, HIV/AIDS, sleep disorder, psychosis, Tourette's syndrome, anxiety disorder and glaucoma. Other possible applications - though with less available evidence - include post-traumatic stress disorder and schizophrenia.

Scientists note that "the limited number of randomized trials for unlicensed cannabis-based products is partly attributable to the regulatory challenges of conducting research on drugs in Schedule I." Thus, it is entirely possible that further applications may be realized as cannabis legislation relaxes in many parts of the world. As it stands, there are no proven uses of the whole cannabis plant (e.g., unprocessed marijuana heads or buds) as a medicine.

The term "medical cannabis" is one that continues to evade definition. Countries have their own interpretations and allow its use for different purposes, based on different evidence thresholds. For investors seeking to make a distinction between recreational and bona fide medicinal cannabis, the separation can be a little hazy.

Investors in cannabis companies should be aware that the term "medical" has been used in international markets as a cover for the sale of recreational products with a high THC content. This issue is perhaps best captured by the European Monitoring Centre for Drugs and Drug Addiction:

> *"Medical marijuana" was legalized by popular vote in California, in 1996, to treat symptoms including chronic pain. As there is no objective test for pain, public access to legal smokable cannabis became a formality.*

So, how can an investor make a distinction between companies with a genuine focus on medicinal outcomes for their clients, versus those companies selling what is effectively recreational cannabis?

THE "MEDICINAL" FIG LEAF

While recreational cannabis is now legal in Canada and some U.S. states, the medicinal fig leaf is alive and well. Some companies continue to claim that their products are intended for medical use -

perhaps seeking the reputational legitimacy afforded by "medical" cannabis – while selling whole-cannabis plant products with high THC contents – in other words, products with an established appeal for the recreational market.

There are two useful indicators for an investor seeking to distinguish between recreational and genuinely medicinal cannabis products:

- The percentage of THC in the product. THC is the ingredient in cannabis that has psychoactive properties, and the higher the level of THC, the higher the consumer will get. To date there is a limited number of properly established studies demonstrating a medical need for whole-plant marijuana products high in THC.
- The nature of the marketing and packaging of the products in question. Many Canadian and U.S. cannabis companies selling "medicinal" products high in THC are marketing them in a distinctly un-medical fashion.

For example, Whistler Medical Marijuana Corp. (a subsidiary of Canadian cannabis giant Aurora Cannabis Inc.) may be considered a misleading name for a company selling high-THC, whole-bud products with strain names including "Grease Monkey," "Bubba Kush," and "Sour Jack."

Given the rapidly developing market and the difficulty of distinguishing genuinely medical products from recreational ones, it is important that investors develop clear processes to enable them to make this distinction. The alternative approach, of course, is to conclude that there are no significant ESG concerns associated with recreational cannabis use, and this distinction is therefore unnecessary.

SHOULD I CARE ABOUT POT IN MY PORTFOLIO?

ESG RISKS

The primary ESG risk for investors in cannabis companies lies in the area of regulation. In the U.S., clashing state and federal laws add a constant layer of uncertainty. Under the federal Controlled Substances Act, cannabis remains classified in Schedule I - alongside heroin. As such, prosecuting the use and sale of cannabis is still within the purview of the Drug Enforcement Administration (DEA), so even companies that are fully compliant with state laws risk conviction for federal offenses. However, the DEA is not actively looking to prosecute cannabis companies; on the contrary, its attitude may be softening. In 2019, the DEA announced its intention to expand and improve access to medical cannabis research at the federal level, which suggests it may be looking to build an evidence-based profile for the federal legalization of medical cannabis.

The inconsistency between state and federal laws poses another ongoing challenge for the industry, which remains "unbanked;" banks cannot legally provide services to cannabis companies under federal anti-money laundering laws. Companies are thus forced to seek alternatives, which often involves the use of enormous amounts of cash. Evidently, this is not ideal, and exposes companies to a range of operational risks.

ETHICAL RISKS

Asset owners globally have a range of policies in place relating to investment in activities judged to pose public health risks – namely, tobacco and alcohol. As noted in a previous update on the ISS

Insights newsfeed, the public health concerns related to recreational cannabis use "place cannabis in a similar category as alcohol and tobacco, where despite the maturity of those markets, there are parallels to be drawn between substances that are intoxicating and have the potential to form dependency."

It is important to examine the macro impacts of a business activity when making ethical investment decisions, rather than focusing on impacts at an individual level. This logic is particularly applicable in the case of cannabis. The potential ethical risks of cannabis relate to the broader implications of possible increased use within the community, particularly in relation to public health and law enforcement.

Like alcohol, cannabis is known to reduce driving skills. It impairs judgment, motor co-ordination and reaction time. Unlike alcohol, however, a direct relationship between the level of THC in the bloodstream and driving impairment is yet to be established, and studies linking cannabis use to likelihood of crash rates have reached varying conclusions. The specific impacts of legalization on motor vehicle accidents also remain unclear. Early evidence from Canada shows that the proportion of respondents who reported driving within two hours of using cannabis did not change with legalization.

Importantly, studies agree on one thing: the combination of alcohol and cannabis impairs driving to a far greater extent than either drug alone. If both are legal, the likelihood of driving when severely impaired (by both cannabis and alcohol) may thus increase.

The risk of cannabis dependence is also concerning. Of those who use cannabis, approximately 1 in 11 will develop a cannabis use disorder. This risk rises to 1 in 4 for daily users. Further, adolescent cannabis use has particularly concerning implications. Some evidence suggests that individuals who use cannabis frequently during adolescence are more likely to develop dependence issues and will be more prone to developing psychotic symptoms in later adulthood. There is also some evidence that smoking cannabis - the traditional method of accessing THC from the whole plant - can be linked with lung cancer.

While these concerns are very valid, the link between legalization and increased community uptake – particularly youth uptake – are not as evident as one might expect. Canada legalized recreational cannabis for adult use in October 2018. Statistics Canada has since conducted quarterly surveys to monitor changing use patterns. By Q4 2019, the prevalence of daily or almost daily use remained unchanged (compared to pre-legalization) at 6%. Early indications further suggest that use among Canadian youth has not increased; on the contrary, between 2018 and 2019, use among 15 to 17-year-olds declined from 19.8% to 10.4%. A slight increase (from 13.1% to 15.5%) has been observed among those aged 25 and older. These findings support a 2019 meta-analysis which found "a small increase in cannabis use among adolescents and young adults following legalization of cannabis for recreational purposes." In the U.S., legalization has been associated with increased use in adults, but not consistently in youth.

It is not yet clear that legalization exacerbates the public health risks associated with cannabis use. Regardless, these risks remain very real and warrant consideration by the ethical investor.

MANAGING THE RISKS OF CANNABIS INVESTMENT

Proponents of the full legalization of recreational cannabis use point to a range of potential positive outcomes, including reducing harm to minor users through regulated access, reducing crime

associated with the criminality of marijuana, and supporting civil liberties for consumers of cannabis. It should be noted that the majority of these outcomes can be achieved through decriminalization.

Another positive cited is the additional taxation revenue associated with a regulated market. However, there is some question as to whether such revenue would be impacted by lower prices in a legal market, particularly given that the legal market must remain competitive with the black market if consumers are to be tempted towards the regulated industry.

The legality of an industry does not necessarily mean that it is an appropriate inclusion in a responsible investor's portfolio. In addition to simply considering the impacts of cannabis on the individual consumer, it is imperative that investors also consider the society-level impacts. When considering investment in the cannabis industry, investors may reach a number of reasonable conclusions:

- The benefits to society of legalizing cannabis will outweigh the ESG risks;
- Investment in cannabis is appropriate for genuinely medical purposes, but recreational cannabis use is to be avoided, given the ESG risks associated with its widespread use; or
- Investment in cannabis is to be avoided.

In each case, investors should define the materiality thresholds needed for determining whether a company's involvement in cannabis warrants further scrutiny.

Once an investor has amended their responsible investment policy to include this additional set of criteria, they should take appropriate steps to ensure that the policy is properly implemented. This will include accessing research on the topic and, for asset owners, discussions with outsourced fund managers – particularly international managers operating in the growth or small-cap space.

And, of course, the investor should include this policy development process in their communications with investors and stakeholders. This may mean involving the stakeholders in the discussion process or, alternatively, communicating the results of the process once it has been implemented.

Those investors with strict tobacco screens should consider the similarities between that industry and a mature cannabis industry when deciding whether to add recreational cannabis companies to their exclusion list. The ISS ESG Sector-Based Screening service provides information to assist investors interested in this area.

A legal cannabis market will not be the romanticized free-for-all envisaged and endorsed by the current industry and its advocates. The pot industry could quite easily go to pot.

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