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Contributing Editors:

David M. Silk & Carmen X. W. Lu
Wachtell, Lipton, Rosen & Katz

ICLG.com

Expert Analysis Chapters

Q&A Chapters

South Africa

Bowmans

Ezra Davids

Ryan Kitcat

1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In 2016, the United Nations Environment Programme reported that "the financial sector in South Africa has been a leader and an innovator in integrating environmental, social and governance (**ESG**) issues into its practices". Regulation has been a key driver of ESG integration in South Africa. In this regard, the main substantive ESG-related regulations create an enabling environment for ESG, and are as follows:

For pension funds, Regulation 28 of the Pension Funds Act, 1956 requires a pension fund and its board to "before investing in and whilst invested in an asset consider any factor which may materially affect the sustainable long-term performance of the asset including, but not limited to, those of an environmental, social and governance character". The Regulation does not prescribe what ESG factors must be considered, instead requiring *any* factor that may materially affect the sustainable long-term performance of an asset to be considered.

- Environmental aspects of concern in South Africa include climate change, energy, water scarcity and usage, biodiversity, destruction of natural habitats, pollution, and waste management.
- Social issues include employment and labour issues, employee benefits, diversity, health and safety, human rights, community relations, and the manner in which broad-based black economic empowerment (**B-BBEE**) (government policy and legislation aimed at redressing historical race-based inequalities) is advanced.
- Governance matters include corporate structure and management, strategic direction and oversight, compliance, anti-bribery and corruption, board composition, and executive compensation.

The Financial Sector Conduct Authority (**FSCA**), a regulator, has issued guidance on Regulation 28 that makes the consideration of ESG factors integral to evaluating the sustainability of an asset. It describes "sustainability" as "the ability of an entity to conduct its business in a manner that primarily meets existing needs without compromising the ability of future generations to meet their needs". Conducting business sustainably includes managing the interaction of the business with the environment, the society and the economy in which it operates, towards a better long-term outcome. Evaluating the sustainability of the business of an entity includes the consideration of economic factors and ESG factors. The "sustainability of an asset" implies the sustainability of the entity giving rise to the underlying value of the asset.

While Regulation 28 applies to pension funds, it has had a marked influence on the ESG practices of other institutional investors and asset managers in South Africa.

Insurers, including life insurers, non-life insurers and reinsurers, are required to prepare their investment policies in accordance with Prudential Standard GOI 3, issued by the Prudential Authority (**PA**). This requires an insurer's investment policy to, among other things: (i) set out the insurer's strategy for investing, including asset allocation strategies and how these will be managed; and (ii) take into account any factor that may materially affect the sustainable long-term performance of assets, including ESG factors.

The Public Investment Corporation (**PIC**) Amendment Act, 2019 was signed into law in 2021. In terms of the amendment, the PIC, a state-owned company responsible for managing public pension fund assets, is now explicitly required, when investing deposits, to consider "the benefit of the members or beneficiaries of the respective depositors" and "the corporation must, as far as possible, seek to invest to … promote sustainable development". The PIC is by far the largest asset management firm in Africa with over R2 trillion worth of pension fund assets.

Specific ESG-related laws and regulations have also been promulgated, for example, in respect of carbon tax, energy efficiency, and a national minimum wage.

A revised draft Code for Responsible Investing in South Africa (**CRISA**) 2.0, a voluntary initiative that seeks to guide institutional investors in developing and implementing sustainable, responsible and long-term investment strategies, was published for comment in November 2020. It sets out various principles and practice recommendations with a clear emphasis on ESG and broader sustainable development issues. It also proposes a shift from an "apply or explain" to an outcomes-based, "apply and explain" application regime. Draft principle 1 of the revised draft CRISA contemplates: "Investment arrangements and activities reflect a systematic approach to integration of sustainable finance practices, including the identification and consideration of materially relevant ESG and broader sustainable development considerations." Principle 2 places a greater emphasis on the diligent discharge of stewardship activities: "Investment arrangements and activities demonstrate the acceptance of ownership responsibilities (where applicable) and enable diligent discharge of stewardship duties through purposeful engagement and voting." Its practice recommendations propose that "investment arrangements and activities should incorporate mechanisms that support the diligent discharging of stewardship duties generally and particularly as it relates to ESG and broader sustainable development concerns".

The above are also supplemented by a well-developed corporate governance framework in various laws and the King Codes prepared by the Institute of Directors of Southern Africa, of which the King IV Report on Corporate Governance for South Africa, 2016 (**King IV**) is the latest iteration. King IV sets out 17 principles that an organisation either must or should apply in order to substantiate a claim that it is practising good governance, reflected in four outcomes: ethical culture; good performance; effective control; and legitimacy. Many asset owners and investment managers subscribe to King IV and take it into account in their governance. Insurers and public companies whose shares are listed on the Johannesburg Stock Exchange (**JSE**) are obliged by the JSE Listings Requirements to apply King IV, and report on their application of King IV principles and recommendations in their annual integrated reports.

King IV regards sustainability as an element of the value creation process relevant to all organisations, and emphasises sustainable development as "a primary ethical and economic imperative". Principle 17 of King IV recommends that the board of an institutional investor should ensure that responsible investment – an approach that incorporates ESG factors into investment decision making, to better manage risk and generate sustainable long-term returns – is practised by the organisation to promote good governance and the creation of value by the companies in which it invests. To this end, an organisation must adopt a recognised responsible investment code, principles and practices.

Principle 3 of King IV, with respect to pension funds only, requires that the board should ensure that the fund is seen to be a responsible corporate citizen, which requires that its investment analyses and practices take account of sustainability, including ESG considerations.

1.2 What are the main ESG disclosure regulations?

Under the current disclosure regime in South Africa, there is no explicit duty to provide disclosures on ESG matters. However, JSE-listed companies are subject to general continuing disclosure obligations under the JSE Listings Requirements, which apply to financially material ESG issues. Additionally, the JSE requires JSE-listed companies to annually report, on an "apply and explain" basis, the extent to which they have complied with King IV. This is often in an integrated report, which King IV describes as a "concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term". ESG is an important aspect of the integrated report, informed by guidance and standards from several frameworks, including the Global Reporting Initiative (**GRI**), International Integrated Reporting Committee (**IIRC**), the Financial Stability Board's Task Force on Climate-related Financial Disclosures (**TCFD**) and the Sustainability Accounting Standards Board (**SASB**). JSE-listed companies publish ESG and/or sustainability reports annually.

The EU regulation on sustainability-related disclosure in the financial services sector (**SFDR**) came into effect on 10 March 2021. The SFDR lays down "harmonised rules for financial market participants and financial advisers on transparency regarding the integration of sustainability risks, the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products". The SFDR is expected to be influential in the development of mandatory disclosure of ESG matters in South Africa.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

King IV recommends that the responsible investment code adopted by an institutional investor in terms of Principle 17, and the application of its principles and practices, should be disclosed. CRISA Principle 5 recommends that "institutional investors should be transparent about the content of their policies, how the policies are implemented and how CRISA is applied to enable stakeholders to make informed assessments". The draft revised CRISA goes a step further by incorporating into each of the other principles focused implementation and reporting elements, in addition to a transparency principle.

Given these recommendations (and pressure from beneficiaries and other stakeholders), institutional investors often publish ESG policies and/or ESG reports, as well as *ad hoc* communications in respect of ESG matters. The FTSE/JSE Responsible Investment Index Series and FTSE ESG Ratings have been influential in promoting ESG disclosures. South Africa's level of ESG disclosure is one of the highest rated in the world among emerging and developed markets assessed by FTSE.

On climate change, the TCFD recommendations, which seek to improve and increase reporting of climate-related financial information, have had some influence locally and are used by NGOs in corporate accountability campaigns.

1.4 Are there significant laws or regulations currently in the proposal process?

The National Treasury, as part of its ongoing Sustainable Finance initiative, recently published a draft Technical Paper 2020: Financing a Sustainable Economy, the objectives of which are to:

- define sustainable finance for all parts of the South African financial sector including banking, retirement funds, insurance, asset management and capital markets;
- take stock of the global and national financial sector policy, regulatory and industry actions taken to date in dealing with environmental and social risks and opportunities;
- identify market barriers to sustainable finance and the implementation of environmental and social risk management best practices; and
- identify gaps in the existing regulatory framework and recommend actions required of regulators, financial institutions and industry associations.

The draft Technical Paper regards "sustainable finance" as an overarching concept that incorporates ESG and contains a number of ESG-related recommendations relevant to the financial sector and to specific participants within it, which recommendations indicate the potential future direction of law and regulation affecting the sector insofar as ESG is concerned. Pursuant to one of the recommendations, to "develop or adopt a taxonomy for green, social and sustainable finance initiatives, consistent with international developments, to build credibility, foster investment and enable effective monitoring and disclosure of performance", a draft taxonomy for green, social and sustainable finance initiatives for the South Africa financial services industry has been developed and in June 2021 was circulated for commentary. An updated draft is expected to be released in the fourth quarter of 2021.

The draft Technical Paper was developed by a working group involving around 50 stakeholders, including regulatory agencies and industry associations: the South African Reserve Bank

(**SARB**); the FSCA; the PA; the Department of Environmental Affairs (**DEA**); the South African Insurance Association (**SAIA**); the Banking Association of South Africa (**BASA**); the Association for Saving and Investment South Africa (**ASISA**); the JSE; and Batseta – Council of Retirement Funds (**Batseta**).

1.5 What significant private sector initiatives relating to ESG are there?

CRISA is a significant private sector initiative for advancing ESG and sound stewardship practices in South Africa, particularly given its broad and influential membership. The revised draft CRISA code mentioned above retains similar core concepts to the first code but has introduced some shifts to align with global and local developments.

In 2011, Batseta launched the Sustainable Returns for Pensions and Society project, which set out to empower South African retirement funds to comply with Regulation 28 of the Pension Funds Act and CRISA. The project featured extensive consultation with the South African retirement investment industry over a two-year period and culminated in the release in 2013 of Responsible Investment and Ownership – A Guide for Pension Funds in South Africa. The Responsible Investment and Ownership Guide seeks to promote responsible investment by supporting South African retirement funds with the integration of ESG considerations into their investment processes. It provides guidance on the development of the policies, procedures and protocols necessary to meet the requirements of best practice, including those set out in Regulation 28 of the Pension Funds Act.

The JSE was the first stock exchange globally to introduce a sustainability index measuring companies on indicators related to ESG. Since 2015, the JSE has partnered with FTSE Russell, the global index provider, to establish the FTSE/JSE Responsible Investment Index Series. It has adopted the FTSE ESG Ratings methodology, and aligned with FTSE Russell's ESG criteria and assessment process. This enables eligible JSE-listed companies to form part of a global group of corporates whose disclosure practices are assessed against ESG factors. The comprehensive methodology and expanded access to data provide investors with increased opportunities to integrate ESG considerations into their investments. The JSE also runs an annual Responsible Investment/ESG Investor Briefing to enable investor engagement on ESG issues.

In the growing impact investing space, which is investing with the intention to generate social and/or environmental impact in addition to financial return, the recently established National Task Force for Impact Investing South Africa is a coalition of public and private sector high-level decision makers whose role is to identify gaps on the supply and demand sides of the impact investing market in South Africa and work together to address those. The Task Force's mission is to accelerate and "increase the deployment of capital that optimises financial, social and environmental returns".

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Due to its role in capital distribution, the financial services sector is integral to achieving sustainable development. Generally speaking, institutional investors and asset managers in South Africa recognise the importance of ESG and are taking steps to improve integration of ESG into their operations. As noted above, pension funds, insurers and the PIC are obliged by regulation to take account of ESG factors in their investment activities. Trade associations and industry bodies in the financial sector have been influential in promoting ESG in South Africa, through the development and adoption of industry standards and guidelines (for example, through participation in the National Treasury's Sustainable Finance initiative described above).

In line with international trends, university endowment funds are under increasing pressure to become more sustainable. The University of Cape Town established a University Panel for Responsible Investment (**UPRI**) committee to oversee the institution's approach to responsible investment as it relates to its endowment fund. The UPRI recently developed a Responsible and Sustainable Investment Policy. Additionally, the UCT Retirement Fund also surveyed its members for their opinions on responsible investment and sustainability issues, which led to the appointment of a new investment advisor with a strong ESG advisory and implementation track record. The Fund is also in the process of amending its investment policy. As thought leaders with considerable endowments, universities can exert influence through integrating ESG into their investment practices.

Investors are able to influence ESG conduct through their investment mandates and investment management agreements concluded with investment managers.

The majority of investors and asset managers support CRISA and apply its principles, though the manner in which they do so varies considerably. As mentioned previously, many institutional investors will regularly publish ESG policies and sustainability reports dealing with ESG issues. There is also a growing number of ESG-related products being provided by the various asset managers.

Active ownership is encouraged by King IV and CRISA. The draft CRISA recommends institutional investors to: (i) demonstrate the acceptance of ownership responsibilities and enable diligent discharge of stewardship duties through purposeful engagement and voting; and (ii) adopt a collaborative approach where appropriate to promote acceptance and implementation of the principles of CRISA and other relevant codes and standards, to support the building of capacity throughout the investment industry and enhance sound governance practices.

Institutional investors have shown a willingness to engage collaboratively with companies and can exert considerable influence in driving change on ESG issues.

As regards pension funds, FSCA Guidance Notice 1 recommends that a fund's investment policy statement (**IPS**) and investment mandate reflects, among other things: (i) how the fund intends to monitor and evaluate the ongoing sustainability of the asset that it owns (or that it intends to acquire), including the extent to which ESG factors have been considered by the fund, and the potential impact thereof on the assets of the fund; and (ii) the fund's active ownership policy. It defines "active ownership" as the prudent fulfilment of responsibilities relating to the ownership of, or an interest in, an asset. These responsibilities include, but are not limited to:

- guidelines to be applied for the identification of sustainability concerns in that asset;
- mechanisms of intervention and engagement with the responsible persons in respect of the asset when concerns have been identified, and the means of escalation of activities as a holder or owner of that asset if these concerns cannot be resolved; and
- voting at meetings of shareholders, owners or holders of an asset, including the criteria that are used to reach voting decisions and the methodology for recording voting.

Where a fund holds assets that limit the application of ESG factors, sustainability criteria or the full application of an active ownership policy, the IPS should state the reasons why the limitation is advantageous to the fund and its members. Alternatively, the IPS should set out the remedial action the fund has taken (or intends to take) to rectify the position. If no such remedial action is being considered or taken, the fund may set out the reasons for that.

As of November 2021, there were 64 South African-headquartered signatories to the UN Principles for Responsible Investment (**PRI**). The PRI provides a framework for its international network of investor signatories to incorporate ESG factors into their investment and ownership decisions. In order for the financial services industry to effect significant change, a large part of the industry needs to subscribe to the same vision and the PRI framework is useful in achieving this.

Stewardship activities are relatively common, with King IV, and the principles in CRISA and the PRI, setting best practice. The draft CRISA has placed significant emphasis on stewardship activities. In practice, asset owners will often outsource stewardship activities, and sometimes the specific philosophy and approach for stewardship, to an investment manager to deal with pursuant to its contracted stewardship and ESG undertakings.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

A number of non-profit and public benefit organisations are involved in advocacy, engagement, stewardship activities and shareholder activism with a view to promoting ESG and exerting influence on institutional investors (such as pension funds, insurers and mutual funds) and asset managers.

The RAITH Foundation and Just Share seek to use "advocacy, engagement and activism to support active ownership and responsible investment", and regularly propose resolutions on various ESG issues. Recent campaigns have sought to have resolutions tabled at listed companies' annual general meetings (**AGMs**), which would require the companies to disclose and/or report to shareholders on: climate risk; plans to address climate-related transition risks; assessments of greenhouse gas emissions in financing portfolios; and policies on lending to coal-fired power projects and coal mining operations, oil & gas, or carbon-intensive fossil fuel activities, and commit to a hard deadline for enhanced disclosures related to climate risk. These activities have been particularly successful in pushing climate-related and coal-lending policies and disclosures in the South African banking sector.

The Centre for Environmental Rights (**CER**) has a corporate accountability team that seeks to engage with companies, investors and industry associations to improve disclosures and transparency on the environmental impact of their activities, expose corporate failures to comply with environmental laws, and promote shareholder activism to compel compliance with environmental laws and disclosures It also engages in litigation on environmental matters.

King IV requires a company to have a stakeholder engagement policy, and with increasing awareness of ESG issues, companies can expect greater engagement from other stakeholders on these issues. Because there is an interdependent relationship between an organisation, its stakeholders, and the organisation's ability to create value, King IV advocates a stakeholder-inclusive approach "in which the governing body takes account of the legitimate and reasonable needs, interests and expectations of all material stakeholders in the execution of its duties in the best interests of the organisation over time".

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

The National Treasury, which is overseen by the Ministry of Finance, is responsible for policy creation for private and public sector investment and as it relates to ESG. The SARB is responsible for developing appropriate monetary policy and overseeing the banking sector.

The Financial Sector Regulation Act, 2017 introduced a "twin peaks" model of financial sector regulation in South Africa, with the object of achieving a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in South Africa. It established two regulators: (i) the PA, within the SARB, tasked with prudential regulation; and (ii) the FSCA, tasked with market conduct regulation.

The PA is responsible for the prudential regulation of insurers. The FSCA's functions include regulating and supervising the conduct of various financial institutions (particularly in relation to the provision of financial services), including pension funds, insurers and collective investment schemes, in accordance with applicable "financial sector laws", including: the Pension Funds Act, 1956; the Long-term Insurance Act, 1998; the Short-term Insurance Act, 1998; the Financial Advisory and Intermediary Services Act, 2002; the Collective Investment Schemes Control Act, 2002; the Financial Markets Act, 2012; and the Insurance Act, 2017.

In order to achieve their respective objectives, the PA and the FSCA are empowered to make prudential standards and conduct standards, respectively, or joint standards, in respect of financial institutions. These standards relate to various matters including the governance and operation of financial institutions, and investment activities, including ESG. One such standard is the abovementioned Prudential Standard GOI 3, which requires an insurer's investment policy to consider ESG factors.

The JSE – which is a PRI signatory and a founding signatory of the Sustainable Stock Exchanges Initiative – is also a significant regulator insofar as listed companies are concerned, and has been very influential in promoting the adoption of King IV's recommended practices, and enhancing corporate transparency and performance regarding ESG and sustainability practices in South Africa.

All of the above regulators are taking part in the National Treasury's Sustainable Finance initiative described at question 1.4 above, and we expect the recommendations in the draft Technical Paper to be pushed by the regulators in the coming years.

2.4 Have there been material enforcement actions with respect to ESG issues?

There has been no material enforcement action with respect to ESG issues in the past year. However, with the increasing emphasis on ESG in South Africa, enforcement risk is expected to increase.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The principal ESG-related litigation risks concern inaccurate or misleading ESG reporting and disclosures, including in respect of climate change. From a securities law perspective, the

Financial Markets Act, 2012 makes it an offence to publish, in respect of past or future company performance, any statement, promise or forecast that is, at the time, and in the circumstances in which it is made, false, misleading or deceptive in respect of any material fact and that the person knows, or ought reasonably to know, is false, misleading or deceptive. The risk will rise as companies more regularly report to shareholders and stakeholders on their ESG conduct and with ESG concerns gaining increasing prominence in investors' choices.

There is also the potential for litigation in respect of a company's activities or performance, from an ESG perspective. Companies in natural resources and commodities industries are particularly exposed to ESG challenges and potential class actions, as was illustrated in the high-profile silicosis class action brought against more than 30 mining companies in 2015.

2.6 What are current key issues of concern for the proponents of ESG?

The main issue of concern for proponents of ESG is to move beyond virtue signalling and bare minimum compliance to a more proactive approach to ESG.

Different approaches to ESG in different industries and within industries make it difficult to compare ESG performance. Added to this is a lack of capacity and expertise in ESG, requiring training on ESG integration.

The lack of standardised reporting and disclosure on ESG makes achieving quality, comparable, relevant and timely disclosures difficult. Linked to this are difficulties associated with a plethora of different reporting standards. This has led BlackRock, the world's largest asset manager, to call for a single, globally recognised set of sustainability reporting frameworks and standards. In this regard, towards the end of 2020, the International Business Council of the World Economic Forum, in collaboration with the Big Four accounting firms, unveiled jointly developed ESG reporting standards with 21 core metrics and 34 extended metrics, addressing issues ranging from emissions to pay and gender ratios to governance targets.

In South Africa, screening out companies with questionable ESG further reduces an already relatively small investment universe for investors and asset managers.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The board of a company is primarily responsible for the management of the business and affairs of a company, including ESG. It is the board that sets and changes the strategy of a corporate entity with regard to ESG.

Pension funds have a board that is tasked with directing, controlling and overseeing the operations of the fund, including in respect of ESG issues and investment strategy, in accordance with applicable laws and the rules of the fund. Regulation 28 of the Pension Funds Act, 1956 specifically links the board's fiduciary duties with giving adequate consideration to ESG. The board of the fund consists of various subcommittees, including an investment subcommittee that is tasked with addressing the fund's investment activities and its investment strategy.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

As noted above, the board is primarily responsible for management of ESG issues. As to supervision thereof, public companies and those that attract high levels of public interest (measured with reference to a public interest score) are required to have in place a social and ethics committee (**SEC**). The function of the SEC is to monitor and report on various matters, including in respect of ESG-related matters.

The SEC is required to monitor a company's activities, having regard to any relevant legislation, other legal requirements or prevailing codes of best practice, with regard to matters relating to:

- social and economic development, including the company's standing in terms of the goals and purpose of the 10 principles set out in the United Nations Global Compact Principles, the Organisation for Economic Co-operation and Development (**OECD**) recommendations regarding corruption, the Employment Equity Act, 1988, and the Broad-based Black Economic Empowerment Act, 2003;
- good corporate citizenship, including its: (a) promotion of equality, prevention of unfair discrimination, and reduction of corruption; (b) contribution to development of the communities in which its activities are predominantly conducted or within which its products or services are predominantly marketed; and (c) record of sponsorship, donations and charitable giving;
- the environment, health and public safety, including the impact of the company's activities and of its products or services;
- consumer relationships, including the company's advertising, public relations and compliance with consumer protection laws; and
- labour and employment, including the company's standing in terms of the International Labour Organization Protocol on decent work and working conditions, and the company's employment relationships and its contribution towards the educational development of its employees.

The SEC is also required to draw matters within its mandate to the attention of the board as occasion requires. It also reports, through one of its members, to the shareholders at the company's AGM on the matters within its mandate.

ESG conduct and reporting is ultimately undertaken for the benefit of shareholders and stakeholders. Shareholders conceivably have the most significant role to play in holding management accountable with respect to ESG. This is achieved through engagement, stewardship activities and shareholder activism, all of which are gaining prominence. Shareholders also have the ability to elect board members or to ultimately divest. Investors also play an important role through their investment choices.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

The practice within JSE-listed companies of including ESG performance measures governing the vesting of short-term and long-term incentives is gathering momentum, with increased focus by institutional investors and other stakeholders on ESG outcomes. Examples of such ESG-related performance conditions include safety (Long Time Injury Frequency Rate and Fatalities), measures of ESG training and compliance, risk metrics, environmental and safety "near misses", greenhouse gas emissions, water usage, employment of members of nearby communities, and measures of transformation, diversity and inclusion.

When present, the weighting of ESG conditions ranges from 10% to 30% of the full scorecard.

Further explicit adjustments to reflect fatalities are also prevalent within South African listed mining companies.

Further remuneration provisions to address major ESG failures are included in malus (pre-vesting forfeiture) and clawback (post-vesting payback) conditions that are now being included in the variable remuneration policies of many JSE-listed companies. Examples of such malus and clawback ESG-related trigger events include fatalities, major environmental incidents such as spills and emissions, risk and compliance failures, gross negligence and bringing the company into disrepute.

Changes to section 30A of the Companies Act have been proposed that will require the disclosure of the pay gap between the highest-paid and the lowest-paid executives in a similar manner to that required by the US Dodd-Frank Act.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

It is increasingly common for companies (and most of the leading institutional investors) to adopt and publish an ESG policy or responsible investment policy that informs their approach to addressing ESG matters in their corporate and/or investment activities. An element of this is ESG risk management, which is becoming increasingly important, with companies putting in place more sophisticated processes to identify, manage and mitigate ESG risk.

Examples of how some companies integrate ESG into their daily operations are:

- fostering a corporate culture of ethics and appropriate conduct;
- taking ESG into consideration during risk assessments and due diligences of new business partners;
- employee training on ESG; and
- the continued implementation of COVID-19 safety protocols.

As regards the investment process, a 2019 study by the CFA Institute and PRI found that:

- governance issues are systematically incorporated into the investment process for equities and corporate bonds more than 50% of the time, but social and environmental issues are incorporated in similar ways only about 25% of the time. Survey respondents expect that environmental and social factors will be incorporated into equity values and bond yields more than 60% of the time by 2022;
- social factors appear to be incorporated into the investment process in South Africa more than in other markets visited; and
- regulation drives ESG integration in South Arica more than in other markets, as South Africa's listing standards and government regulations are more explicit about ESG disclosure requirements than those in other markets.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

International lending markets have embraced green loans and sustainability-linked loans (**SLLs**). Over the past four years alone, the volume of sustainable finance has grown 15 times. In South Africa, green and ESG initiatives and the related financings are no longer a theoretical aspiration, but are very much at the forefront for governments, banks and corporates. For example, Mediclinic, an international private healthcare services group, recently completed the refinancing of its Southern Africa division's existing debt through a new sustainability-linked banking facility. By achieving pre-agreed sustainability performance targets, Mediclinic Southern Africa will benefit from a reduced facility margin through an incentive-based pricing mechanism. The targets are directly linked to Mediclinic group environmental and social goals of progressing to becoming carbon neutral with zero waste to landfill by 2030 and improving water efficiency and patient experience.

Ultimately, sustainable finance transactions depend on the nature of each key performance indicator or sustainable performance target, and how measurable it is, as agreed between the borrower and lenders. The finance providers will likely look at several factors when assessing potential financings, with reporting and verification being of primary importance.

Thus far, providers of debt and equity finance have relied both on internally and externally developed ESG ratings, depending on the nature of the transaction and the borrower group. There is a growing trend internationally to ensure that there is at least external verification on an annual basis of borrowers' ESG ratings and to move away from self-certification by borrowers. It is likely that South African providers of debt and equity finance will follow this trend.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds and social bonds play a growing role in the South African market. South Africa is recognised as Africa's most-developed green bond market.

With regard to green bonds, local and international investors have increasingly allocated specific portfolio tranches to ESG themes, and the South African market has seen a significant increase in the issuance of green bonds in the last two years. The JSE actively supports the issuance of green and social bonds and has implemented standards for these types of bonds in amended Debt Listings Requirements (Sustainability Segment), which closely follow the International Capital Market Association (**ICMA**) Green Bond Principles. In 2017, the JSE became the first African exchange to launch a Green Bond Segment and Green Listings Rules.

Recently there have been issuances by institutions at various levels, ranging from development finance institutions to municipals, banks and corporates. Nedbank launched an innovative United Nations Sustainable Development Goals-linked bond in 2020, which represented South Africa's first "green" tier-two capital instrument. The proceeds of this bond go towards funding high-potential solar and wind renewable energy projects. The City of Johannesburg and the City of Cape Town have also (and respectively) issued green bonds to fund various green bond projects, such as Cape Town's water infrastructure and Johannesburg's dual-fuel buses. We expect to see more green bond issuances in the next year.

With regard to social bonds, this is still a relatively new area to the South African market, although it continues to develop. The JSE is currently amending its Debt Listings Requirements to accommodate and prescribe regulations for social bond issuances. Due in part to the health crisis caused by COVID-19 and the loss of the sovereign investment-grade rating, the South African government is facing notable funding requirements and recently considered the issuance of a social bond, the proceeds of which would go towards supplies, staff and equipment in order to fight the COVID-19 crisis in South Africa.

4.3 Do sustainability-linked bonds play a significant role in the market?

Yes, the sustainability-linked bond (**SLB**) market is taking off at a rapid rate in South Africa, with many commercial property companies already issuing SLBs this year. As mentioned above, the JSE is currently amending its Debt Listings Requirements to accommodate SLBs – these requirements will closely follow the ICMA Sustainability-Linked Bond Principles.

4.4 What are the major factors impacting the use of these types of financial instruments?

Some of the main factors driving growth include the UN Framework Convention on Climate Change (the Paris Agreement), which reached consensus to combat climate change and intensify all actions and investments needed for a sustainable, low-carbon future. This includes reducing greenhouse gas emissions by 40% by 2030 and becoming carbon neutral by 2050.

The EU Taxonomy has also been a key driver internationally. It effectively operates as a classification system designed, among other things, to:

- create a uniform and harmonised classification system, which determines the activities that can be regarded as environmentally sustainable for investment purposes across the EU; and
- provide all market participants and consumers with a common understanding and language of which economic activities can unambiguously be considered environmentally sustainable/green.

The National Treasury is currently looking to implement similar measures to classify economic activities in South Africa. The South African working group advising the National Treasury recently released a draft Green Finance Taxonomy.

Furthermore, key loan organisations such as the LMA, APLMA and LSTA have jointly produced the Sustainability Linked Loan Principles and the Green Loan Principles. These are high-level market standards to promote the development and integrity of these loans by encouraging a consistent approach, while recognising, in particular for SLLs, the need for flexibility across sectors. These standards have had and continue to have an impact in the South African context.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

It depends on which green bond compliance framework the issuer is using. According to the ICMA Green Bond Principles (which have been endorsed by the JSE), it is required for issuers to confirm green eligibility criteria and use of proceeds in order to "qualify" for the Green Segment.

It is usual for the issuer to appoint an external reviewer (known as an "independent sustainability advisor") who provides an external review with regard to the issuer's compliance with the Green Bond Principles. The independent sustainability advisor will check and verify the issuer's green bond against the Green Bond Principles and provide certification under the Climate Bond Standards (as appropriate). It is also common practice for the independent sustainability advisor to verify that the green bond has been approved in accordance with respective national and/or regional government regulations.

Currently, South Africa does not have specific green bond regulations at the government level.

It is also worth noting that for sustainability-linked instruments, self-verification of the borrower's performance post-signing is no longer recommended as an option under the revised (and internationally recognised) Sustainability Linked Loan Principles, which means that independent and external verification is required.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

There is a general sense that stakeholders and investors are paying more and closer attention to ESG and questions of sustainability in the light of the unprecedented systemic shock inflicted by the pandemic.

COVID-19 has highlighted the inequality that is prevalent in South African society and as ever, poorer citizens have been impacted disproportionately. This has led people to change their approach to social issues and the impending climate crises, the next systemic shock.

The onset of the pandemic and the uncertainties associated with it, have, in many instances, prompted companies to change how they manage their human capital and to prioritise employee health and well-being.

Crises tend to accelerate change and it appears that the take-up of ESG and sustainability issues has accelerated as a result of the pandemic.

6 Trends

6.1 What are the material trends related to ESG?

ESG will become a core strategic concern for corporates, driven by exogenous and endogenous factors and pressures, including a shift towards a more stakeholder-inclusive capitalism.

Climate change is the key ESG challenge of the coming decades, which we expect will be a dominant theme as governments, investors, regulators and pressure groups increase engagements around climate change.

The trend of increasing pressure on companies and institutional investors to tackle ESG issues is likely to continue. Stakeholders are becoming increasingly proactive in engaging with institutional investors and asset managers on the integration of ESG factors into their decision making and are facing increasing scrutiny of their investment activities and AGM voting records. They in turn are taking a more proactive stance on ESG and in holding management to account on ESG issues.

The EU is intending to launch a carbon border tax adjustment, which will see carbon import taxes imposed on carbon intensive goods. South Africa is particularly at risk of such import levies due to its heavy reliance on coal-generated power. South Africa can expect similar future exogenous pressures as countries attempt to meet their climate change goals. Investment firms will accordingly gravitate towards less-carbon-intensive investments.

ESG-related shareholder activism, which has picked up in recent years, is likely to become more prevalent and sophisticated. Economic activists will also leverage poor performance on ESG to bolster activist campaigns.

ESG and sustainability disclosures and reporting will continue to remain an area of focus, with a gradual shift towards more standardised reporting expected to take place. Linked to this, demand for ESG data, assurance and verification is likely to increase, with improved technology and AI enhancing our ability to interrogate and draw insights from data on ESG factors.

Banks and lenders will take ESG risk into account more than has historically been the case. The shift is already under way in the South African banking sector.

There has been a significant growth in green bonds, green loans, SLLs and bonds. This is due to a number of factors, including the regulatory regime, investor-driven sentiment and the harmonising of market standards, with SLLs being particularly popular because of their flexible nature – we have therefore seen a significant increase of SLLs and SLBs already since the start of 2021.

Recently, several of South Africa's largest institutional investors have committed to using ESG metrics in screening potential investments. Ninety One, South Africa's largest listed asset manager, has also recently become signatory to the Net Zero Asset Managers Initiative, which aligns institutional investing with the global goal of achieving net zero carbon emissions by 2050.

More ESG products are likely to be developed (for example, Old Mutual launched South Africa's first ESG equity fund in June 2020), and more capital is expected to flow towards such products as demand for ESG-friendly assets grows, particularly as millennial investors begin to drive investment activity.

With ESG coming to the fore, executive compensation will be linked, at least partly, to ESG-related metrics.

6.2 What will be the longer-term impact of COVID-19 on ESG?

It is too early to tell what the longer-term impact of COVID-19 on ESG will be.

A poll conducted by JP Morgan of investors from 50 global institutions revealed that the vast majority of investors believe that the pandemic will increase awareness and actions globally to tackle climate change.

In South Africa, there is a general sense that we need to do things better going forward, to shift towards a more environmentally and socially responsible transition from currently unsustainable business models. ESG and sustainability have, rather than fall by the wayside, gained momentum as a result of the pandemic.

As mentioned, COVID-19 has had a devastating impact on society and particularly on those most vulnerable in our societies. Going forward, it is likely that there will be increased awareness around social issues as more people recognise the importance of the social aspect in ESG. Businesses' approach to ESG will be more holistic as they realise that uplifting communities is equally vital to business success as the reduction of carbon emissions.

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Ezra Davids is chairman and senior partner of Bowmans, and specialises in M&A, capital markets, and securities law. Ezra is the most recent chairman of the Faculty Advisory Board of the Law School of the University of Cape Town. He sits on the board of trustees of the Legal Resources Trust (a non-profit human rights organisation using the law as an instrument of justice); is a director of Freedom Under Law (a non-profit organisation dedicated to the promotion of the rule of law in Southern Africa); and is a patron of the Student Sponsorship Programme (a non-profit organisation that enables academically talented, low-income students to excel in South Africa's best high schools). He is also the former chairman of the Recent Developments in M&A Subcommittee of the Corporate and M&A Committee of the International Bar Association and is a regular contributor to international M&A and ECM publications. Ezra was the first practising African lawyer to be featured on the cover of *The American Lawyer*.

Bowmans
11 Alice Lane
Sandton
2146, Johannesburg
South Africa

Tel: +27 11 669 9320
Email: ezra.davids@bowmanslaw.com
URL: www.bowmanslaw.com

Ryan Kitcat is a partner in the Corporate Department at Bowmans, and a member of the M&A practice area. Ryan specialises in public and private M&A and general corporate and commercial law. He has advised JSE-listed and multinational clients on a variety of national and cross-border mandates. He has worked in particular in the energy & natural resources, education, mining, hospitality, private security and telecommunications sectors. His expertise extends to B-BBEE transactions, corporate reorganisations, corporate governance, shareholder activism and takeovers. In 2018, Ryan spent six months on a *StrongerTogether* secondment to the London office of Freshfields Bruckhaus Deringer. In 2019, Ryan completed the Impact Investing in Africa course through the University of Cape Town Graduate School of Business.

Bowmans
11 Alice Lane
Sandton
2146, Johannesburg
South Africa

Tel: +27 11 669 9296
Email: ryan.kitcat@bowmanslaw.com
URL: www.bowmanslaw.com

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