THE REGULATORY CONTEXT FOR RESPONSIBLE INVESTING IN SOUTH AFRICA

A high-level overview of the legal and self-regulation framework for sustainable investment by institutional investors in South Africa

1. INTRODUCTION

Does our legal and self-regulatory framework provide the clarity and support required to enable sustainable investment by institutional investors in South Africa?

South Africa committed itself to substantially reducing its greenhouse gas emissions below its business as usual growth trajectory in early 2010. This commitment to a low-carbon and resource efficient economy poses significant challenges for South Africa given the highly carbon intensive nature of our developing economy and the large amount of funding required to transition to a low-carbon economy. Likewise, there is enormous opportunity for such funding, given the financial size of portfolios held by institutional investors, to be used as a strategic driver of sustainable economic development in South Africa in areas such as climate-friendly energy and infrastructure, energy efficiency, carbon capture and storage and the effective management of water, waste and pollution.

For the purposes of this paper, sustainable or responsible investment is investment that fully considers all risks and rewards of a given investment. It is an approach that explicitly integrates all factors (including environmental, social and governance (“ESG”) considerations) into investment management decisions.

A recent study produced by the International Finance Corporation, SinCo and Riscura has found that sustainable investment “has a strong niche foothold in ... South Africa. Yet more work is needed, at policy and portfolio levels, to grow this investment theme.”

The purpose of this briefing paper is to interrogate, on a high-level basis, whether our current legal and self-regulatory framework provides the clarity and support required to enable sustainable investment by institutional investors in South Africa, and to encourage debate around how such investment can be further stimulated, if at all, from a regulatory perspective.
2. CONCLUSION

There is no doubt that sustainable investment “is no longer just an academic exercise” but the integration of ESG factors into investment decisions remains a work-in-progress...

While the effective implementation of longer-term and more sustainable strategies that integrate ESG factors into investment decisions remain a work-in-progress, recent developments in South Africa’s legal and self-regulation frameworks reflect considerable progress in strengthening market regulation and creating an enabling framework for the greater integration of such factors into the overall investment philosophy of institutional investors.

Regulation 28 to the Pension Fund Act (“Regulation 28”) brings the consideration of ESG factors by institutional investors to the fore. It recognises that these factors must be considered for investors to discharge their fiduciary duties and requires that they be addressed in the investment policy statements of funds, a dynamic document that informs investments made by funds. It requires that a fund and its board must, both before making an investment, and while invested in an asset, consider ESG factors and the impact these may have on the long-term performance of the investment. It enables funds to increase their investments in private equity, which appear to have existing exposure and experience in integrating ESG factors.

But what does this mean for sustainable investment in practice? For this regulation to be effective, ESG considerations must not just be considered, and investments in assets that allow for greater ESG consideration must not just be possible, but be implemented in investment-making decisions (subject to the necessary limits on the discretion and decision-making abilities of fiduciaries).

One of the most effective ways of ensuring the implementation and effectiveness of Regulation 28 is accountability and the reaction of the market. Institutional investors must disclose and be transparent about how ESG considerations underpin their investment decisions and actions. This will enable beneficiaries, asset managers and companies to understand investors’ expectations and requirements for ESG factors to be integrated in the conduct of their operations. In this way, a potential basis exists for each party to be held to account for their decisions and actions. The Code for Responsible Investing in South Africa (“CRISA”) requires, inter alia, that institutional investors disclose the policies underpinning their investment decisions and actions. Although a non-mandatory mechanism, the fact that CRISA has the backing of a number of key players in the investment industry, including the Government Employees Pension Fund (“GEPF”), make signing up to and applying the code a good business decision for institutional investors and their asset managers. “...the realisation that the GEPF would withdraw funds from any investment manager not applying the code was likely to be an effective incentive...”

In addition, other non-mandatory codes like the King Code of Governance for South Africa (“King III”) and the Principles for Responsible Investment...
(PRI)²⁰ have placed renewed focus and emphasis on transparency and good corporate governance. This focus, together with the recent advances from an integrated reporting perspective that require companies to report on the company’s performance in terms of both its finance and its sustainability in an integrated and holistic manner²¹, have created an environment in which business is increasingly focused on, and increasingly being held accountable for its impact on the environment and community in which it operates.

What remains to be seen is whether these market-based incentives will prove effective tools for implementing the principles set out in Regulation 28 or whether additional regulatory measures that encourage active institutional investors and generally incentivise “long-termism” thinking by investors will be required.

3. THE LEGAL AND SELF-REGULATORY REQUIREMENTS FOR SUSTAINABLE INVESTMENT

Institutional investors are bound, inter alia, by their fiduciary duties, relevant legislation and associated regulations, and rules, policies and codes of conduct of the relevant funds...

Many large institutional investors, investment managers and other financial institutions in South Africa have taken account of sustainable investment opportunities for some time.²² Such investors have traditionally focused on issues such as affirmative action, skills development and job creation but there is growing recognition in mainstream investment circles that the integration of ESG factors into investment decisions may also be financially beneficial, and, increasing importance is placed on how businesses interface with society from an environmental and governance perspective.²³ This is reflected by the GEPF, the largest asset owner on the African continent with around $131bn in assets under management in March 2011, development and publication of policies for ESG integration. In turn, the asset manager of 92% of its assets, the Public Investment Commission (PIC), has adopted ESG-integrated investment policies since 2009²⁴. Institutional investors are bound, *inter alia*, by their fiduciary duties, relevant legislation²⁵ and associated regulations, and rules, policies and codes of conduct of the relevant funds. Trends of growing corporate transparency and governance, and belief in the importance of ESG considerations and behaviour that supports sustainable development, have led to the development of two non-mandatory market-based codes of governance in South Africa — King III and CRISA. These codes are intended to give guidance and provide a framework for a governance system for boards of companies, institutional shareholders and their ultimate beneficiaries²⁶. In addition, some institutional investors and asset managers have adopted a number of other voluntary obligations (whether codes of practice or statements of principle) which provide for ESG considerations to figure highly in investment, financial and business decision-making.

This paper sets out a high-level review of the relationship between fiduciary duties and the consideration of ESG issues at common law, the recent amendments to Regulation 28 to the Pensions Fund Act²⁷ and the recently enacted CRISA.
A. FIDUCIARY DUTIES AND ESG ISSUES – WHERE DO THINGS STAND?

The relationship between fiduciary duties and ESG considerations in investment policymaking and practice as expressed in our case law is unclear at this stage but the consideration of ESG factors is arguably legally permissible...

Fiduciary duties are duties that are imposed upon a person who undertakes to exercise a discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence. It is a fundamental principle of our law that institutional investors as fiduciaries must, at all times, act with the utmost good faith and in the best interests of the fund and its beneficiaries (present and future) and with the proper degree of prudence, skill, care and diligence.

Our common law is an important source of fiduciary duties. No case law has yet decided on the relationship between fiduciary duties and ESG considerations in investment decision-making and practice. However, two cases do provide us with some insight into this relationship:

i) In Administrators, Estate Richards v Nichol and another, the court stated, inter alia, that the prudence of an investment depends on the circumstances of each particular case “and circumstances change. An investment considered prudent in earlier times may rightfully be regarded as quite imprudent in the context of modern conditions”.

This case indicates that whether or not an investment is prudent will be decided on a case-by-case basis, and that the prevailing, and perhaps even anticipated future, economic realities are to be taken into account when determining whether an institutional investor’s investment decisions (as trustee) are justified. Trustees are required (subject to the limits placed on their discretion in, for example, the fund documents) to take on an appropriate level of risk (but not speculative) to ensure that they act in the best interests of both present and future beneficiaries. The court did not define what it meant by the term “speculative investments” and there is therefore some uncertainty about what investments our courts may interpret as being “speculative” and not meeting the required fiduciary standard.

This principle arguably allows room for the interpretation (on a case specific basis) that prudent investing (which requires the responsible management of a fund’s assets for both present and future beneficiaries) may require regard for the extra-financial interests of beneficiaries in conjunction with their financial interests, or indeed, the integration of ESG considerations into an investment analysis and decision which is relevant to the long-term performance of the business, and therefore the financial interests of the beneficiaries. Such a consideration will require the trustees to strike a careful balance in acting in the best interests of both present and future beneficiaries.

ii) In the case of Cowan & others v Scargill & others, the court made a number of observations, including that if the trust provided financial benefits, then “the best interests of the beneficiaries are normally their best financial interests.”

The statement that those responsible for managing trusts with a financial purpose are required by their fiduciary duties to put profit maximisation above all other considerations has been perceived by many as being a barrier to the integration of ESG issues into investment decision-making. However, respected legal commentary and opinion suggests that the judgement in the Cowan case has been misinterpreted in that the case did not consider the question of taking ESG considerations into account in investment decisions and the impact this may have of investment returns. Furthermore, it has been argued that the fiduciary duties will still be fulfilled by pension fund trustees who allow for the influence of other relevant considerations “provided they treat the purpose of the investment power (ordinarily the creation of financial benefit) as the primary purpose...” and “...do not allow it to be overridden by any other purpose.”

Therefore institutional investors may arguably have some room to consider ESG issues when making investment decisions at common law. This uncertainty is best resolved at this stage by explicitly requiring that ESG issues be considered in the trust and policy documents of the relevant fund. Regulation 28 (referred to below) does now require investment policy statements to address ESG issues and the interpretation by CRISA that the consideration of ESG factors as part of sound corporate governance and the fulfilment of fiduciary duties by institutional investors will likely influence a court’s interpretation of ESG considerations in the context of fiduciary duties.

The revised Regulation 28 “may be considered a global best practice”\(^{37}\)… it requires institutional investors to consider and apply their minds to sustainable investment...

**Regulation 28 in principle**

Regulation 28 is a legislative endorsement of the principle that institutional investors must look beyond profit to investing responsibly on behalf of their members, and the relevance of ESG considerations to such responsible and prudent investment decision-making.\(^{38}\)

i) Regulation 28 has adopted a combination of a principle and rule-based approach. The revised preamble and the “principles” section, which informs the interpretation of Regulation 28 as a whole, recognizes that ESG factors may influence the investment performance of portfolios and therefore enables funds to take these factors into consideration across all assets and categories of assets. The revised Regulation 28 requires that the investment policy statement, which must be reviewed at least annually, addresses this principle.

ii) Regulation 28 does not exhaustively prescribe how decision-makers should go about integrating ESG factors into their decisions. Rather the principle-based approach allows the decision-makers to determine the approach that will enable them to meet their legal obligations in particular circumstances. This approach is important for two reasons. It enables the substance and purpose of the integration of ESG factors to be properly considered, measured and appraised, and hopefully avoids a ‘tick-box’ compliance mentality that does not provide for the effective integration of ESG considerations. It recognises that the consideration, application and implementation of ESG factors is to a large extent in its infancy in the investment industry, and that sustainable investment is not homogenous enough for the prescriptive imposition of rules which may stifle innovation or have unintended consequences. It therefore allows the flexibility needed to accommodate the change in ESG variables over time and across asset classes.

iii) Regulation 28 enables larger allocations to private equity by major institutional investors. This is of particular importance given the recent findings by the International Finance Corporation, SinCo and Riscura\(^{39}\) that private equity funds:

- manage $14 billion in South Africa\(^{40}\)
- and that this figure is likely to grow rapidly in the next five years;
- already have the involvement of large South African institutional investors such as the GEPF; and
- “have greater exposure and experience in integrating ESG factors in the region than their general asset management counterparts”\(^{41}\).

iv) The codification of these principles is an important way of aligning investors, asset managers, companies and beneficiaries. By requiring that ESG factors be considered in investment decision-making and that they be addressed in the investment policy statement, the consideration of these factors is rendered “mainstream”\(^{42}\).

**Regulation 28 in practice**

“the gap between policy and practice must be monitored…”\(^{43}\)

Regulation 28 was amended following a public and industry consultation process and there appears to be consensus that the changes are “very enabling and supportive”\(^{44}\) for sustainable investing.

The regulation has not been in operation long enough for its effect, or the implementation therefore to be assessed and understood. A few months after the promulgation of Regulation 28, funds were granted an exemption, ending on 31 December 2011, to comply\(^45\). This is a reflection of the effort that effective implementation of the regulation will require; in the adjustment of policies, mandates, investments and monitoring and reporting systems, and fundamentally, in the change in approach to investing.

For this regulation to be effective institutional investors must disclose and be transparent about how ESG considerations underpin their investment decisions and actions. This will enable beneficiaries, asset managers and companies to understand investor’s expectations and requirements for ESG factors to be integrated in the conduct of their operations. In this way, a potential basis exists for each party to be held to account for the performance of their duties in this regard.
C. WHAT IS THE INDUSTRY POLICY FOR SUSTAINABLE INVESTMENT?

“Voluntary codes like CRISA work perfectly if people own both their letter and spirit, and show that they are making an impact...”46

The codification of ESG considerations in responsible investment decision-making and the emphasis on transparency and good corporate governance in the new Companies Act47 have been endorsed by industry in the form of a number of non-mandatory codes48 including PRI, King III and CRISA. These codes are complementary to the recent advances from an integrated reporting perspective that requires companies to report on the company’s performance in terms of both its finance and its sustainability in an integrated and holistic manner.49

CRISA, which was only launched in July 2011, is an institutional investor initiative intended to give guidance on how the institutional investor can give effect to the principles of King III and the PRI, and execute investment analysis, activities and rights so as to promote sound governance and sustainable development50.

The PRI and King III already form an important part of the governance framework in South Africa, informing our understanding of governance and fiduciary duties as set out in legislation and in our case law (referred to above). It is hoped that CRISA will enhance the effectiveness of this framework. It is not possible to evaluate the effectiveness of CRISA at this early stage (the effective date for reporting on CRISA is only on 1 February 2012). However, the following factors are indicative of CRISA's innovative approach:

i) As a non-mandatory market-based code of governance, it is significant that CRISA has the support of, inter alia, the GEPF, the Principal Officers’ Association (POA), the Association for Savings and Investment South Africa (ASISA), the Principles for Responsible Investment and the Institute of Directors. In addition, it operates (as per King III) on an apply or explain basis – placing the onus on the applicant to voluntarily apply the principles, explain how the principles have been applied differently, or why they have not been applied at all51;

ii) The code is robust and forward-thinking in its approach. It is a principle-based approach that encourages best practice by recognising that ESG issues are “mainstream investment considerations”52, and the ability and responsibility of institutional investors to give effect to ESG issues given their fiduciary mandate and share ownership and rights in companies;

iii) The code is wide-reaching in its application. It applies to both institutional investors and service providers, while recognising that the institutional investor remains accountable to its beneficiaries;

iv) The code sets out a number of broad practice recommendations which give institutional investors guidance as to how they can best implement its principles on a day-to-day basis, while allowing investors to determine the approach that will enable them to best comply with the principles in their particular circumstances.

The committee members of CRISA have indicated that they believe it will be possible to judge the effectiveness of CRISA within the next six to twelve months. The CRISA committee has been retained to oversee the initial period of implementation to assess the effectiveness of its implementation. Finance Minister Pravin Gordhan has indicated that the government may have to look for “other solutions”53 should CRISA not have the desired impact in terms of encouraging responsible investment by institutional investors54.
1 The purpose of this briefing paper is to provide a high-level overview of the legal and voluntary framework for responsible investing by institutional investors in South Africa for information and discussion purposes in the non-legal arena. This information, while based on sources that the writer considers reliable, is not guaranteed as to the accuracy thereof, and does not purport to be complete. Legislation, policies, standards and guidelines considered in this briefing paper are, to the best of the writer’s knowledge, current as at 15 August 2011. The preparation of this report has included desktop reviews and research of the relevant legislative provisions, the common law and various articles published on sustainable investing in South Africa; and interviews conducted with investors, advisors and legal professionals active in investment in South Africa in August 2011. In particular the insights of Mr. Malcolm Gray (Investec), Mr. Francisco Khoza (Bowman Gilfillan Attorneys), Professor Mervyn King and Mr. Graham Sinclair (SinCo) are gratefully acknowledged. The research and commentary, in particular that contained within the following reports, are also gratefully acknowledged: “Sustainable Investment in Sub-Saharan Africa: Investment practitioner views of sustainable investment in private equity and asset management in South Africa, Nigeria, and Kenya”, July 2011, International Finance Corporation, SinCo and RisCura; “A legal framework for the integration of environmental, social and governance issues into institutional investment”, October 2005, UNEP Finance Initiative and Freshfields Bruckhaus Deringer; and “Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment”, July 2009, UNEP Finance Initiative. Views and any errors in this briefing paper or in the interpretation of reports, papers or commentary on which the writer has relied, are the writer’s own. Given the high-level nature of this briefing paper, the writer has focused on institutional investors in the form of pension funds

2 South Africa’s letter to the Climate Change Convention Secretariat following the Copenhagen Accord (29 January 2010) where South Africa committed itself to domestic targets of reducing its greenhouse gas emissions to 34% below the business as usual growth trajectory by 2020, 42% below the business as usual growth trajectory by 2025, plateau to 2035 and begin declining in absolute terms from 2036. These commitments are not legally binding at this stage. South Africa has also ratified the United Nations Framework Convention on Climate Change (1997) and the Kyoto Protocol (2002). Also see The National Climate Change Response Green Paper (November 2010). The White Paper was expected to be promulgated in June 2011. The Green Paper does reflect the makings of a progressive and inclusive domestic policy on climate change. It broadly sets out what needs doing and reflects an attempt at a coordinated approach by government to the issue of climate change adaptation and mitigation. However, it is also the subject of much criticism, principally being that the Green Paper does not provide for sector specific measurable targets or how these targets are to be met and enforced.

3 (in addition to other factors)

4 Given our status as a developing country, it is accepted that our contribution to the overall global target of emission reductions is based on the principle of common but differentiated responsibility (Part 1 of The National Climate Change Response Green Paper (November 2010))

5 http://sri-extra.blogspot.co m accessed on 11 August 2011: “Investing in a Green Economy: theme, sector or hybrid”, 12 April 2010

6 It was reported on http://www.africainvestor.com/article.asp?id=9057 accessed on 15 August 2011 that the assets of retirement funds within South Africa are in excess of ZAR 1.5 trillion and the asset base of government-sponsored funds close to ZAR 1trn


8 The writer uses the terms “responsible investing” and “sustainable investing” interchangeably in this briefing paper. Given the high-level nature of this briefing paper, the writer has focused on the environmental component of “ESG” factors

9 According to the IFC, Sinco and RisCura July 2011 report (“Sustainable Investment in Sub-Saharan Africa: Investment practitioner views of sustainable investment in private equity and asset management in South Africa, Nigeria, and Kenya”), issues such as governance, climate change, water use, diversity, human rights, worker health and safety,
job creation, education, local ownership, community infrastructure development, the need for employee health care to supplement public health care coverage for HIV/AIDS or water treatment systems would all be considered as sustainability/EGS factors.


12 Institutional investment is made up of various types of funds including public and private pensions, collective investment schemes and insurance reserves. Given the high-level nature of this briefing paper, this paper does not address all forms of institutional investment nor each form of institutional investment in any amount of detail and focuses in the main on pension funds. The term “institutional investors” refers generally to institutional investors as asset owners and to the service providers of institutional investors unless the context otherwise determines

13 Anne-Marie D’Alton, CEO of the Principal Officers Association as quoted on http://www.sincosinco.com/siinssa.php accessed on 13 August 2011

14 Promulgated under Government Gazette No. 34070, dated 4 March 2011. Regulation 28 covers prudential investment guidelines and governs permitted levels of exposure to different asset classes

15 Act No 24 of 1956, as amended

16 The Code for Responsible Investing in South Africa, July 2011; Institute of Directors in Southern Africa


19 The King Code of Governance for South Africa 2009, Institute of Directors in Southern Africa

20 Launched in 2006 by then UN Secretary-General Kofi Annan. The process of developing the UNPRI was jointly managed by the UNEP Finance Initiative and the UN Global Compact


22 A number of large institutional investors and investment managers have been signatories to the United Nations Principles for Responsible Investment (UNPRI) for some time already including (from the perspective of institutional investors) the Government Employees Pension Fund of South Africa (GEPF) and Eskom Pension and Provident Fund, as indicated on http://www.unpri.org/signatories/. In addition, a number of financial institutions have also been signatories to the UNEP Finance Initiative (UNEP FI) for some time (http://www.unepfi.org/signatories/index.html?&no_cache=1). Both UNPRI and UNEP FI are voluntary declarations of intent. Also see the Financial Sector Charter in terms of the Broad-Based Black Economic Empowerment Act.


25 Given the high-level nature of this note we have only considered Regulation 28 to the Pensions Fund Act in detail. However, there are a number of other relevant pieces of legislation that inform ESG considerations. In respect of environmental considerations alone these include section 24 of the Constitution, the National Environmental Management Act, The National Water Act (No 36 of 1998, as amended), the National Environmental Laws Amendment Act, The National Environmental Management: Air Quality Act, The National Environmental Management: Biodiversity Act, The National Environmental Management: Waste Act, The National Energy Act and The Electricity Regulation Act.

27 Act No 24 of 1956, as amended
28 “A legal framework for the integration of environmental, social and governance issues into institutional investment”, October 2005, UNEP Finance Initiative and Freshfields Bruckhaus Deringer
29 This is in accepted principle of our case law reflecting in a number of cases including Sackville West v Nourse and Another 1925 AD 516; Cowan & others v Scargill & others [1984] 2 All ER 750 (ChD); Administrators, Estate Richards v Nichol and another 1999 (a) SA 551 (SCA) and TEK Corporation Provident Fund & others v Lorentz 1999 (4) SA 884 (SCA). This principle is also set out, inter alia, in the Financial Institutions (Protection of Funds) Act 28 of 2001 (as amended), the Pension Fund Act 24 of 1956 (as amended) and its Regulation 28 (as amended), Circular PF No. 130: Good Governance of Retirement Funds, a guidance note issued by the Financial Services Board.
30 1999 (i) SA 551 (SCA). Note this is a Supreme Court of Appeal decision and its findings will therefore be binding on lower courts in South Africa. The statement regarding the change in circumstances was however not a finding of the court and will therefore be considered persuasive but not binding on our courts.
31 1999 (i) SA 551 (SCA) at pg 557
33 1999 (i) SA 551 (SCA) at pg 552
34 [1984] 2 All ER 750 (ChD). Note this is an English law case, but its findings, and therefore the commentary in respect of this case will likely be considered as persuasive (though not binding) in South African courts.
35 “A legal framework for the integration of environmental, social and governance issues into institutional investment”, October 2005, UNEP Finance Initiative and Freshfields Bruckhaus Deringer, pg 87
36 Although beyond the scope of this briefing paper, as is also referred to in “A legal framework for the integration of environmental, social and governance issues into institutional investment”, October 2005, UNEP Finance Initiative and Freshfields Bruckhaus Deringer, there is also arguably a professional duty of care on institutional investment consultants and asset managers to raise ESG considerations.
38 It expressly requires trustees to consider “any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance character.” See also the “Explanatory Memorandum on the final Regulation 28 that gives effect to section 36(i)(bB) of the Pensions Fund Act 1956” prepared by National Treasury, dated 23 February 2011.
40 According to the IFC, Sinco and RisCura report referred to above, this figure is at June 2011 and includes funds raised and capital deployed and managed.
42 Note that section 2(c) of Regulation 28 provides that the fund retains the responsibility for the compliance with the principles set out therein, whether or not third parties are appointed and required to perform in accordance with the principles of regulation 28
43 www.africainvestor.com/article.asp?id=9057 accessed on 15 August 2011
44 Andrew Canter (Futuregrowth, CIO) as quoted in www.africainvestor.com/article.asp?id=9057 accessed on 15 August 2011
45 Notice No. 1 issued by the Financial Services Board; 10 June 2011

47 No 71 of 2008, as amended

48 Other important voluntary codes which have been widely endorsed and accepted in South Africa but are not dealt with in further detail in this paper are the Principles for Responsible Investment (UNPRI), the Equator Principles, the UN Global Compact Principles and the Carbon Disclosure Project


50 The Code for Responsible Investing in South Africa, July 2011; Institute of Directors in Southern Africa


52 The Code for Responsible Investing in South Africa, July 2011; Institute of Directors in Southern Africa; pg. 4


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