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ESG and good corporate governance in relation to the use of pension funds: Comparison between the United Kingdom and South Africa (The Report)

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Introduction

Before we can analyse the efficacy of Environmental, Social and Governance (ESG) in relation to pension funds in the City of London UK and South Africa we must assess the progress that has taken place to date, both positive and negative. The City of London is in advance of South Africa in its development of ESG as a tool for good corporate governance and understanding of intangible assets and valuation; while South Africa is in the early stages of doing so especially in relation to their companies integrating ESG into practice. What is clear is that support for good governance when allocating investment in pension funds should ensure that the right choices are made by pension fund managers and trustees to encourage the environmentally sustainable and socially beneficial use of the often, huge sums raised by pension savers. This imperative is as important in the City of London as it is in South Africa. Mitigating climate change is probably the most urgent imperative at present.

The importance of such pension fund savings cannot be underestimated. The United Nations has estimated that US$ 90 trillion is needed in global investment to mitigate the effects of climate change by 2030, as outlined in the Paris Accords. To date, ESG branded assets constitute US$ 30 trillion which is nearly one-third of the US$ 100 trillion global bond market. Unfortunately, it is unclear how much of this ESG investment supports environmentally sustainable infrastructure as recommended by the United Nations (UN). Rather than supporting sustainable debt which is used to finance concrete environmental goals such as environmentally friendly infrastructure, ESG bonds are used to refinance or repackage bad debt, which is not useful for environmental goals such as those set by the Paris Accords. This means that in real terms sustainable debt related to the UN goals for climate change mitigation only amounts to US$ 2.2 trillion of which US$ 1 trillion constitutes green bonds.

In recent months, there have been a number of climate commitments, especially in the case of transportation activities which account globally for at least 16 per cent of CO2 emissions. Britain has promised to cut emissions by 78 per cent by 2035 from the levels found in the 1990s. Additionally, international shipping (Shipping Innovation Press Release for London International Shipping Week, 2021) and aviation will be included. The United States Biden Administration, the world's largest economy and one of the largest contributors to carbon emissions, has committed to reducing emissions by 50 per cent compared with levels of 2005. (Moulds, *The Times,* 28 April 2021).

Without good governance, the good intentions of ESG may be undermined in its encouragement of markets to join, through asset placement, the global fight against climate change caused by fossil fuel burning, industrial scale livestock farming and outdated transportation methods for example, all of which accelerate global warming.

This Report will discuss the problems inherent in setting regulatory guidelines, whether they be governmental like the SEC (Securities Exchange Commission) in the United States (US) for securities, the FCA (Financial Conduct Authority) in the UK or a metric analysis quantitatively assessing how the target of the pension fund investment provides genuine support for sustainable debt. Such debt includes green bonds or a qualitative analysis of what the target investment has actually achieved in real terms in support of UN climate goals. Even certification by ratings agencies concerning compliance with ESG can have its pitfalls.

An example of such problems would be the US$ 6 billion green bond that was issued by Mexico in 2016 for the construction of a new airport. The external reviewer was Sustain Analytics, which authenticated the green credentials of the bond. The bond stated that the building would be made with low emission concrete, a sustainable material, despite the fact that the increased flights and road traffic would increase emissions directly related to global warming. An unforeseen political variable that entered the ESG equation was the political appointment of a new president of Mexico who stopped the project on the grounds of corruption. The ratings agency, Standard & Poor, then withdrew its certification leaving the bonds as green ones despite the fact that no one would know how the money would be spent and no provision was made for payment default, hence the investors could not retrieve their loans.

This is just one example of how ESG investment in green environmental projects can be fraught with problems, even as one as basic as whether an airport can ever be viewed as green if it increases emissions. The demand that a green project reports annually on its progress failed in the Mexican case in terms of good governance accountability, as the investors could not retrieve their monies because the issuer did not default. A downgrade in green ratings would not have assisted either, as this would have meant that investors lost the market value of their investment which could make ESG investments seem like a greater risk (Philip Aldrick, *The Times*, 24 April 2021).

This raises the question then of how we can ensure that good governance is maintained when pension fund money is targeted as ESG investment. Clues may be found in the development of ESG in one of the most developed and oldest global financial markets, the City of London, which in this Report shows how much the London investor markets influenced their counterparts in South Africa, especially in insurance and the Johannesburg Stock Exchange (JSE Ltd).

Among the ongoing problems for ESG investment that the Report addresses are twofold;

One, is the suitability of those chosen to be pension fund managers who are trusted with making ESG investment decisions that affect the company stakeholders such as directors, shareholders and the beneficiaries of ethical pension investing.

Two, another highly important aspect guiding shareholders, company directors and pension fund managers are the issues concerning economic and social value in ESG choices. It is this issue of intangible assets and valuation that is more advanced in the City of London, UK, in comparison to South Africa. It is also the least understood aspect of ESG. If investors in ESG do not fully grasp how to value what a future ESG investment choice is offering, the wrong choices will be made as with the example above and opportunities missed. The final part of the Report will assess the problem for ESG investment of intangible assets not appearing on balance sheets. (Taplin, 2013)

History of ESG development in the City of London (the City)

Philanthropy vs. ethical investment of pension fund monies

The broad background of philanthropy vs ethical investment of pension funds may be traced back to the American economist Milton Friedman who also influenced the City of London (the City) arguing in the sixties and seventies that philanthropic considerations lowered the profitability of investment. (Milton Friedman and Rose Friedman, 1980).

This perspective was seriously challenged in the new millennium where ideas of socially responsible investment and investors began to emerge. In 2001 Mike Tyrell's Jupiter Fund began to use ESG based research for financial giants HSBC and Citicorp in the City. Then in 2002 Chris Yates-Smith of the City of London became involved in the international development of the Organic Food Standard. He became a founder of one of the leading brand consultancies establishing an early environmental finance research group. An informal group of financial leaders, lawyers and NGOs became known as the Virtuous Circle which examined environmental social standards and financial performance.

In 2005, the UN Environment Programme Finance Initiative commissioned a report from the international law firm based in the City, Freshfields, Bruckhaus, Deringer. The report concluded that it was not only permissible for investment companies to integrate ESG issues into investment analysis but that it was an essential part of their fiduciary duty to do so.

(Freshfields, Bruckhaus, Deringer, 2005)

While in 2006 there was a move away from Milton Friedman's arguments as Michael Barnett of Oxford University and New York University's Robert Saloman published an influential study showing that social responsibility and financial performance had a complimentary and a curvilinear relationship.

(Michael Barnett and Saloman, Robert, 2006)

In 2008 a survey of global investment managers conducted by AXA Investment Managers and AQ Research found that the majority of professionals preferred the term ESG to describe such data.

In 2014, the Law commission of England and Wales confirmed that there was no bar on pension trustees and others taking account of ESG factors when making investment decisions. (Law Commission, 2014)

In September 2015, in a report, 'Fiduciary Duty in the twenty-first century' by the PRI, UNEP enquiry and UN Global Impact concluded that "Failing to consider all long-term investments, value-drivers, including ESG issues, is a failure of fiduciary duty".

In 2016, a Natixis survey of Defined Contribution Plan Participants, 6 in 10 participants agreed that that they would be more likely to increase their contributions to retirement plans if they knew their investments were doing social good. (Natixis Global Asset Management, Investor Insight Series, 2016).

Therefore, there are no legal impediments nor lack of will for pension fund investors to invest in ESG. It is encouraged, discussed and even seen as a legal, fiduciary duty. Yet, impediments remain as outlined in the introduction and in The Report which need to be addressed sooner than latter.

History of ESG development in Johannesburg

Philanthropy vs. ethical investment of capital

ESG or economic, social and (good corporate) governance principles have probably been part of any business enterprise since the start of the Roman Empire. The Roman Empire had certain unique forms of business enterprise, similar to contemporary friendly societies, in other words a form of insurance company to look after the social well-being of their "members" (Wettenhall, 2019, pp. 3; Friendly Society Act of 1956). However, it was not always properly documented by "auditors" or "boards of directors", partly because it was not necessary to report on those principles in any report or to explain the enterprise's perception of what amounted to good corporate governance.

It is difficult to explain when good corporate governance practices emerged in Johannesburg or in South Africa (Skidelsky, 1998, pp. 52-56). Research on a well-known South African insurance company that was registered in Cape Town on the 1 March 1918, Santam (Suid-Afrikaanse Nasionale Trust en Assuransie Maatskappij) and a few months later Sanlam (Suid-Afrikaanse Nasionale Lewens Assuransie Maatskappij) in June 1918 explains the day-to-day business operations of these two insurance companies a century ago (Verhoef, 2018, pp. 48-80). The far-sighted management and operational practices of Santam/Sanlam illustrate the organisational values and principles underlying good corporate governance practices as a business tool to achieve socioeconomic upliftment and development after the First World

War in South Africa (Mackey and Sisodia, 2013, pp. 273). This is also evident in the present – the Sanlam Group of Companies conducts business in 77 countries, employs over 110 000 employees and manages more than R900 billion in investments in South Africa, for example either as a pension fund or fund manager (Sanlam About Sanlam, 2021).

A century ago, sustainable business practices were a hands-on-daily-management approach. Sanlam/Santam's board of directors created a day-to-day management committee (Dagelijks Bestuur [daily management]) which consisted mainly of directors to ensure administrative oversight and accountability on all business operation levels. For Santam/Sanlam, this approach was the key to sustainable business practices and to understanding how to maintain and promote socioeconomic upliftment and development (Verhoef, 2018, pp. 48-86).

A century ago, Santam/Sanlam built schools and other community centres, employed people (irrespective of whether they were Afrikaans or English speaking) and designed insurance products that would benefit their policyholders (Giliomee, 2003, pp. 348-435). These activities were not mentioned in Santam/Sanlam's financial statements, but it is possible to observe in the minutes of their meetings their “good” corporate behaviour and socioeconomic impact (Sanlam Archives, 1920). A century ago, investors would not have required any disclosure of the above circumstances to understand Santam/Sanlam's social responsibility towards South Africa. For example, Santam/Sanlam appointed a London-born Jewish woman, Sarah Goldblatt, as the first marketing officer and or editor manager. Having displayed, on her arrival in South Africa, an immediate aptitude for the Afrikaans language, she was able to perform all the necessary language editing and translating of official publications and letters to be circulated to all policyholders – keeping them up to date or informed on the business affairs of Santam/Sanlam. None of the foreign companies operating in South Africa at the time appointed either English or Afrikaans-born South Africans in either managerial positions or directorships. Those positions were reserved for men born oversees. This may sound irrelevant, but when Santam/Sanlam was registered, approximately 74 insurance companies operated in South Africa (CCP 1890/1909). At that time, the Santam/Sanlam board of directors and the manager corps consisted of the founders and other South African-born men, as well as highly experienced men from Scotland, the Netherlands among others to compete against these 74 insurance companies (Beukes, Ehlers and Verhoef, 2018).

In another example observed in the minutes of more than a century ago, Santam/Sanlam invested money in the Free State Board of Executors (Hagedorn-Hansen, 2016, pp. 75-144). This was not a particularly successful investment, and a few years later the Free State Board of Executors collapsed financially. Santam/Sanlam then took the unprecedented business decision to invite its shareholders to reclaim their investments. In other words, Santam/Sanlam, which had used investors' capital to acquire 60% control in the Free State Board of Executors, refunded each and every shareholder.

The history of good corporate governance in Johannesburg can also be traced back to the early 1960s when the London Institute of Directors established a branch in South Africa, Johannesburg (Institute of Directors in South Africa Time Line, 2021). The branch was not truly South African but was influenced by the London head office to attract Southern African members. During the 1960s, 1319 Southern African directors joined the Johannesburg branch. The membership increased steadily over the years until the early 1990s when it reached 1500 members. It was only in 1992 that the Institute of Directors commissioned Professor Mervyn King (former Appeal Court Judge of South Africa) to compile South Africa's first report on corporate governance (King I, 1994). In Chapter 20, this report lists the business enterprises that are subject to King I, in other words, subject to good corporate governance principles. Whether pension funds, or even fund managers, were part of those listed enterprises is not clear. King I has a requirement demanding compliance by enterprises as defined by the Financial Services Act(s). However, it is not clear what Act the Financial Services Act(s) refers to. The reference could relate to the Pension Fund Act of 1956 which was largely amended by the Finance Act of 1957, or the Financial Institutions Amendment Act of 1962 etcetera. Whatever the case, during the 1990s, the Pension Funds Act was amended by the Financial Services (Board) Act of 1992 and one may therefore assume that Professor Mervyn King had this Act in mind with its inclusion of pension funds and other similar forms of enterprises, for example fund managers.

In Chapter 20 paragraph 9.2, King I, has a requirement in its (sustainability) reports and/or communications to promote greater transparency in business operations, and it is possible to interpret paragraph 9.2 to include the following: how a pension fund should consider (investments in) environmentally friendly companies, looking at their employment policies, business strategies, social relations and/or good corporate behaviour. King I did not provide a list of "things" for communicating or disclosing the above, but it was the beginning of voluntary disclosure of good corporate practices, commonly known as integrated reporting (Kilian, 2010). Although King I did not require the presence of a day-to-day management board, as explained earlier in our Santam/Sanlam example, in paragraph 9.5.3 it did require effective internal controls to maintain sustainable business or investment practices on a daily basis. This may refer to a voluntary audit committee to assist the board of directors to create a successful business plan (strategy) or help the board to disclose integrated reporting. It was therefore the first time in South African corporate governance history that a document tried to explain good corporate governance practices and how to disclose these practices voluntarily in the financial statements and/or other reports/communications (Du Plessis and Rühmkorf, 2015). The latest version of the corporate governance report, King IV, was issued in 2016 and regulates the current corporate governance landscape in South Africa. This document remains the benchmark for measuring what amounts to good corporate governance practices in South Africa (King IV, 2016).

Good Corporate Governance in the City of London

The essence of good corporate governance in relation to ESG investment in the City is that the investment practices are not only good for society and the environment but that make business and investment sense. Skilled pension fund managers are realising that the unbridled greed of the eighties is no longer acceptable especially with the climate change imperative. This awakening is reflected in practical financial decisions of what is the best pension fund investment in terms of return and social, economic and environmental good. The FTSE4Good index of ethical stocks has surpassed the FTSE 100 index of leading UK stocks over a period, of one, three, five and ten years. The MSCI World SRI Index for socially responsible funds has also surpassed the MSCI World Index over similar periods as the FTSE4Good index.

Ethical investment can only occur if the fund managers are carefully chosen for their dedication and skills in steadfastly and methodically researching and finding the funds that consistently support ESG in Interactive Investor for example. This can be done by looking at the Fund’s ranking in supporting ESG and at its holdings which will indicate quite clearly if they are ESG friendly. An example would be Baillie Gifford Positive Change that invests in companies which make major contributions to solving social and environmental issues. For the entirety of 2020 it was a top selling fund at Interactive Investor with a £2 billion fund that saw returns of 83 per cent in that year. Started in 2017, it became the fourth best performer of the 349 funds in the IA Global sector. Two of its holdings not only fit into the ESG remit but have been providing exceptional returns. One is Tesla, the major electric car manufacturer that is seriously producing electric cars in the U.S. and Moderna the biotech firm that has produced effective and affordable COVID vaccines for global use. In 2020, shares for the former rose by 365 per cent while in the latter by 834 per cent.

Appointing skilled and dedicated fund managers are the essence of good corporate governance in relation to ESG investment because once savings are pooled into a fund, the fund manager becomes a shareholder; who has the ability to find and ensure that companies chosen for pension fund investment have proactive and responsible policies and consistent actions in terms of ESG.

As a matter of course, asset management firms are involved in up to thousands of engagements a year that make recommendations through letters to CEO’s and Advisory Board meetings to ensure ESG standards are met. (Thomas, *The Times*, 2 February 2021)

The most effective corporate governance is that supported by regulation. In the U.S. for example, the SEC created regulation such as Sarbanes-Oxley, to ensure security companies comply with good corporate governance legislation; fining them if they do not comply. The City of London companies also have to comply with legislation (for example the FCA financial regulators) that curbs excesses in greed and malpractice. In relation to ESG the UK for example, has been developing policy that ensures that the producers incur the costs of managing packaging once it becomes waste. Recycling effectively and according to regulation is a cornerstone of genuine policy that will cut carbon emissions. It is subscribing to the practice of the circular economy in which waste and carbon is drawn out of the system by reusing all products and materials produced by firms large and small. A non-profit organisation, The Ellen McArthur Foundation has estimated if Europe, India and China adhered to a policy of reuse, carbon emissions could be cut by 44 per cent by 2050. An example of a company that collaborates with the Ellen McArthur Foundation is DS Smith which is developing circular design principles. It sold its plastics business in 2020 and concentrates now on collecting recycled cardboard from industrial customers, supermarkets and select local authorities, to recycle into new paper and cardboard boxes. DS Smith also will give good returns as it had £6 billion in revenues in the year to April 2020. (Moulds, *The Times*, 5 May 2021)

Supported by current and forthcoming increased taxes on plastic the pace of transitioning from plastic to recycled cardboard for packaging is quickening as is the practice of the circular economy.

Therefore, finding fund managers who are skilled in understanding the circular economy and which companies are adhering to the government regulation that support it are the ones who will choose companies who practice good governance in relation to ESG.

What constitutes good governance in South Africa?

To understand good corporate governance from a Johannesburg perspective, it is important to focus on the most recent King report, King IV. In the foreword, Professor Mervyn King describes, in brief, good corporate governance as being based on three legs, namely inclusive capital, sustainable business practices (business plan) and integrated reporting (King IV, 2016).

This sounds simple, but each leg is further complicated by the following characteristics associated with good corporate governance, namely, ethics, the organisation in society, corporate citizenship, sustainable development, stakeholder inclusivity and integrated thinking. Many businesspeople, boards of directors, lawyers and auditors do not fully understand the meaning of these (Kilian, 2010). For example, to invest in a company or company listed on the JSE Ltd on the basis of good financial results alone does not comply with the principles associated with sustainable or responsible investments as good corporate behaviour (Bernardi and Stark, 2018). Financial results are not an indication of either good or bad corporate governance principles. For example, a profitable company that shows good financial results may abuse human rights within its social relations or harm the environment as a result of its business operations (Buniamin and Ahmad, 2018). However, a company that protects the environment (we assume) will be more financially sustainable in the long term. In other words, by protecting the environment or following good corporate practices, the company will be more successful in the long term than a company that destroys the environment or its social relations (Camilleri, 2015). For this reason, to understand the future sustainability of their investments, pension funds and fund managers must know whether a listed company in which they invest protects the environment or not as an example (Kelly and Fussell, 2015).

Although the three legs mentioned in the foreword of Professor King above do not refer to the environment explicitly, they fall within sustainable (business plan) practices. On the other hand, the notion of a move from financial capitalism to inclusive capitalism could relate to employees who have obtained shares in their employer – the company. If a listed company has a very poor employee turnover rate (for example, average employment duration is 3 weeks) it shows that financial success is more important to that company than the well-being of its employees or, in other words, to reject the inclusive capitalism of the company (Human Rights Council, 2008). Inclusive capitalism focuses on the "quality of life" of not only company employees but of everyone who is doing business with that particular company in its supply chain as part of protecting good social relations.

Professor Mervyn King specifically refers to developing economies and companies from developed states that should try to improve the quality of life of their employees and the other people/stakeholders in the supply chain of the company (Bilchitz, 2016). On paper this sounds simple, but in practice this inclusion of the supply chain is far more complicated. The following supply chain example serves to illustrate this. Unilever sells tea (among many other things) and in order to sell tea successfully and sustainable, there are various people or stakeholders in Unilever's supply chain (Unilever Website, 2021). Paying these entities in the supply chain more money and teaching their employees or business owners how to look after their environment is a financial burden on Unilever that could result in lower profits. But, as a result of these interventions, the employee(s) or business owner(s) in the supply chain will produce more with less, for example cultivating more tea on their land by promoting sustainable farming practices. The employee(s) or business owner(s) will know how to look after their land, thus benefiting Unilever as a business partner and the community in which the owner operates as a whole, making them good corporate citizens. For this reason, we may assume that pension funds and fund managers are looking for companies similar to Unilever. One is able to detect such companies and their practices by reading their integrated financial or sustainability reports. These reports are generally used by pension funds/fund managers to direct their future sustainable investments (Nien-he, 2004).

Pension funds/fund managers rely on integrated reporting to make informed investment decisions. The boards of directors of both listed and unlisted companies must be able to disclose, in addition to ESG, a suitable business plan (strategy) and how it supports ESG and whether the business plan is part of the three legs mentioned earlier, for example a leg is further explained as inclusive capital (social upliftment) or not (Aquila, Swayer, Friestedt, Bander and Drayton, 2020). Disclosing this information as part of integrated reporting may pose some difficulties, for example external auditors rely on directors' explanations of their business strategies and how the strategies support ESG. It is not only external auditors that should be reporting on this; any external service provider may report on any business strategy of any company in any suitable format, for example on a listed company's website or in a relevant published sustainability report.

Using transparent disclosures, pension funds and fund managers could draft a form of tick-box questionnaire to understand listed companies' commitment to sustainable business practices. For this reason, King IV does not give clear examples of how a questionnaire should look in practice (King IV, 2016). As an alternative, South African pension funds/fund managers may refer to MSCI's (an American fund manager) tick-box questionnaire to understand how and when investments form part of long-term sustainability (MSCI ESG Metrics, 2020).

The South African Companies Act of 2008 requires a listed company to establish an internal audit committee on which a director may also serve. This committee is an ideal platform for taking note of the company's business plans (strategies) and how it relates to the environment, social relations and good corporate behaviour (Companies Act 2008, ss 94(7)(g)(ii and iv), 94(7)(h) report on any related matter). In addition, it is advisable to introduce a human resources director (who is not a full-time employee of the company) to be part of that audit committee (Companies Act 2008, s 94(4)(b)(ii)). In this regard, this person could draft company disclosure policies/reporting practices or "practical documents" with the necessary guidelines on how the audit committee should identify and report on relevant business strategies and how the company complies with ESG – to promote integrated thinking as explained in Professor King's foreword (Companies Act 2008, s 94 (7(h)).

The introduction of "practical documents" guides the company on compliance with ethical principles for example. In other words, ethics requires integrated reporting or in other words full disclosure (Collier and Esteban, 2007). If a company is not dedicated to transparent disclosures, this lack could very easily be interpreted as unethical reporting (King IV, 2016). Pension funds and fund managers will generally be able to "test" relevant disclosures by reading other relevant sources, for example the newspaper reports explaining the business activities of that company (Thompson, 2020). If a journalist is reporting on a specific business strategy and there is no mention of that strategy in the financial statements or other sustainability reports, then pension funds/fund managers might conclude that the company is not dedicated to transparency. For this reason, appropriate communication should take place between the audit committee, the board of directors and also external auditors (Companies Act 2008, s 94(h); Susko, 2018). Non-disclosure will also indicate that the company does not understand the role of pension funds/fund managers in assessing its sustainability.

Business skills for achieving financial success are no longer a characteristic of good corporate behaviour. Today, business skills to achieve financial success within the ESG parameters are an indication of long-term success and sustainability (Tarmuji, Maelah and Tarmuji, 2016). For this reason, business persons and board members can receive training on how to interpret or apply King IV in practice (Institute of Directors In House Training, 2021).

ESG integration

A comprehensive approach needed

As each company has a different product or service, the only way to understand ESG compliance is to assess how well ESG issues are integrated into a company's practices.

DS Smith, a company mentioned above, is a good example of an ESG integrated firm. The COVID pandemic has strangely speeded the move towards a circular economy. In the case of DS Smith, the company offset its losses by a decline in demand from its industrial customers through its increased sales of recycled cardboard boxes as shoppers turned en masse to online shopping. Online shopping outlets which rely heavily on packaging to deliver their products meant a surge in demand for cardboard as use of plastic packaging is discouraged by increasing regulation.

This forward thinking of practicing the circular economy model means that the cost of collecting and recycling the cardboard has become an integrated part of its business that has institutionalised the recycling practice into its everyday existence. In 2020 this led to a dividend yield of 3.5 per cent which is acceptable to shareholders such as pension fund managers and their investors. (Moulds, *The Times,* 5 May 2021)

Another industry the COVID pandemic has had a great effect on is pharmaceuticals. Prior to the pandemic pharma had a reputational problem seen as a reservoir of greed, graft, a tendency for vast wastage and anti-social priorities. It would never have been associated with ESG investment. This has all changed with the rapid development of vaccines to defeat the deadly COVID virus.

AstraZeneca was not known for its vaccine business but in April 2020 it made a made a collaboration with the University of Oxford to develop a COVID-19 injection that has been approved in more than 70 countries and has produced 190 million doses that have been distributed worldwide at zero profit. This led not only to a better reputation but a buyout of Alexion for US$ 39 billion, an American biotechnology company, that will give it access to one of the fastest growing market for medicines for treating rare diseases by building immune systems to defeat such disease. Rapid growth is following but at a reasonable price and with a current 2021 dividend yield of 3 per cent. The vaccine at zero profit and the development of rare disease medicine which are both for the social good shows an integration of ESG principles with a promising return on investment for pension fund managers. (Moulds, *The Times*, 7 April 2021)

In relation to the environmental part of ESG for example, the bottom line in choosing ESG compliant companies is not whether they are best in class or through benchmarking but whether the practices are genuinely good for ESG issues and are integrated into the company's actions fully while offering good corporate governance and economic value.

Another risk shown clearly which effects the efficacy of ESG investment is integrated data collection. This may be seen clearly in international shipping. The City was the first post industrial revolution centre for shipping activity including established trade such as the East India Company and in insurance developed in Lloyd's of London. South Africa was involved in these City developments as well.

Shipping is now in the forefront of developing ESG performance based on decarbonisation, crew welfare and greater transparency. ESG is re-defining shipping throughout the maritime industry including supply chains.

Yet, the major impediment to an integrated ESG strategy is the lack of comprehensive data with which to achieve it. Data remains fragmented and out of date. The importance of data driven insights for shipping may be seen in recent spending to improve data collection. In 2020, a survey by Optimas showed that spending on ESG data collection in 2021 will most likely reach USD one billion.

A radical new integrated data collection on ships is moving forward with vessels becoming data collection centres while at sea. This is being facilitated by Low Earth Orbit (LEO) satellite networks which are enabling real time monitoring, the exchange of data and ship-to-ship connectivity and integration among vessel based digital systems.

In relation to the environment, for example, such satellite-based monitoring systems can relay in real time, data on fuel usage, carbon emissions and maintenance requirements to arrange for maximum efficiency that reduces carbon footprints. (Plessy, *Splash 24/7*, 19 August 2021).

Facilitating ESG integration in South Africa

a) How much progress has been made by pension fund managers/trustees to integrate ESG into their investment decisions?

On pages 17 and 18, the Discovery Medical Aid Integrated Report 2020 explains the company's environmental approach and social responsibilities, for example the company has 75% black employees (without stating the specific ethnicity), 40% women in managerial positions, a 14.6% turnover rate on 13 000 employees (approximately 1898 employees are leaving Discovery every year and new employees are appointed), reduction in electricity usage (not explained how this is achieved), reduction in water usage (not explained), reduced carbon footprint (not explained), 84% employee engagement (not clear what this entails), and R1.5 billion spent on uplifting black businesses in South Africa (not explained in detail) (Discovery Medical Aid, 2020). The report also mentions the impressive financial results for 2020, reasons why the monthly premiums of policyholders as stakeholders would be increased in the middle of 2021 (taking note of the costs of the Covid-19 pandemic). Discovery should perhaps explain the reasons for the monthly premium increases and its high employee turnover rate. For example, how does Discovery assist the 1898 employees who are leaving the company annually – how many of those employees retire? Are there any training programmes to assist those employees to find alternative employment? Although Discovery is probably implementing such training programmes, it is not properly explained in the sustainability report. Good corporate governance practices pertaining to shareholder value are also explained on page 17, although the phrases used to explain shareholder value are brief and non-descriptive (Discovery Medical Aid, 2020). It is therefore suggested that Discovery should explain its business plan (strategy) or growth model in greater detail on page 21. The average employee's salary (or shareholding) is not disclosed in the report too. This is very important for understanding employee remuneration packages which form part of the social relations leg of ESG, for example inclusive capital.

Discovery has issued 665 768 601 shares (authorised share capital is R1 000 000 000 000 (one trillion rand)) to various investors/shareholders and fund managers on behalf of pension funds, and the market capitalisation stands at R95 278 144 489 trillion. Price to earnings ratio is 1052; the dividend paid by Discovery equals R1.01 per share in 2020. Perhaps, instead of increasing policyholder monthly contributions in the middle of 2021, Discovery could have avoided paying any dividends to its shareholders to compensate for monthly increases (Discovery Moneyweb, 2021). The Discovery share price decreased by 2.65% in the middle of 2021, and year (2021) to date it decreased by 7.16%. On the other hand, a year ago (2020) the share price increased by 45.66%. Currently, the share price stands at R143. Bearing in mind that Discovery has been disclosing sustainable reports since 2016 on their website, one could draw the unconfirmed conclusion that there is a link between the growth in share price and the disclosure of sustainability reports since 2016. The daily (average) number of shares traded on the JSE Ltd amounts to 3 229 183, although in 2018 the CEO Allan Gore bought nearly 900 000 shares. Therefore, in practice, we do not know how many of these 3 229 183 shares were bought by pension funds/fund managers or whether they were speculative transactions.

The Government Employees Pension Fund (GEPF) is one of the major investors in Discovery Medical Aid, and the mere fact that the South African government wants to nationalise medical schemes should be an indication that this type of business model for Discovery is not sustainable in future. The effect of nationalisation is read in any South African newspaper, and its consequences should be disclosed to allow a pension fund to determine its future financial losses (Rose, 2021). The sustainability of the future business operations of all South African medical aids cannot be ignored, and no document is available in which a pension fund or fund manager has argued against nationalisation (Writer, 2021). Discovery has already foreseen the consequences of nationalisation, and has created a Discovery Bank as a way of protecting to some extent the future existence of Discovery.

The precise relationship between pension funds and fund managers that invest on behalf of the GEPF is not clear. Do such pension funds still purchase Discovery shares irrespective of future nationalisation plans? Or do they explain the consequences of nationalisation to their contributors to the funds? We have been unable to obtain any form of document to this effect. In contemporary times, the uncertainties relevant to the future existence of private hospitals and medical aid schemes in South Africa are of great concern. If the South African government could manage public hospitals as financially sustainable by providing healthcare to each and every citizen on the same international level as South African private hospitals do, then there would be a future for nationalisation in South Africa. Until then, private hospitals or Medical Aid Schemes will always be a political argument between those citizens who have access to good healthcare, and those citizens who do not as a result of the misappropriation of public hospital funds (Corruption Watch Corruption in the Health Sector, 2021).

Sometimes there is no need to read a company’s sustainability report because of the very nature of the company's business strategy/model. Sasol is a South African company that specialises in fossil fuels. Because fossil fuels cause great environmental harm, how should Sasol disclose the environmental leg in its financial statements as a sustainable business strategy? It is probably not possible to produce less harmful fossil fuels. For this reason, we may assume that any pension fund that invests in Sasol is only concerned with financial results, dividends and the like. The biggest pension fund that invests in Sasol is the GEPF (Sasol Moneyweb, 2021). The trustees and directors of this fund should consider alternative investments that will be more sustainable in the long term, benefiting their contributors at retirement age. It is also not clear who the fund managers are who acted on behalf of the GEPF. The Sasol share price is R224 and market capitalisation is R141 008 448 450 (trillion), the dividend paid was R5,90 per share in January 2019. The authorised share capital is 1 127 690 590 (trillion) and issued shares number 627 876 251. Three years ago (2018), the share price decreased by 50%, and one year ago (2020) it increased by 148%. Volume trade per day on the JSE Ltd is 1 378 799 shares. However, we do not know how many of these shares are bought by fund managers or whether they are part of speculative share transactions. The price-to-earnings ratio is 157. In this regard, we may assume ESG plays a very small role in the purchasing of Sasol shares.

If one considers the above, it would appear that the GEPF is oblivious to the consequences of the effects of nationalisation and fossil fuels in future. ESG in this regard has very little persuasive meaning for this pension fund or the fund managers who act on its behalf. We may assume that financial indicators remain the most important investment tool for explaining the increases in share price, for example Sasol's share price.

In 2010, there is a Financial Services Appeal Board (currently Financial Services Tribunal) determination in *Metropolitan Collective Investment Schemes Ltd v Registrar of Collective Investment Schemes* (no case number). Metropolitan is a licensed collective investment scheme or unit trust provider which entitles it to act as a fund manager for pension funds and for private individuals. A pension fund can therefore approach such a fund manager to select certain listed shares that are ESG compliant. In 2010, Metropolitan rented out its licence to 154 individual fund managers who in turn obtained funds either from private individuals or pension funds, and invested those funds on the JSE Ltd. These 154 fund managers were referred to as "white label" portfolios. According to the "rental agreement", each fund manager could choose its own listed share portfolio and Metropolitan would not be liable for any incorrect or poorly executed investment decisions. Subsequently, a complaint was lodged with the Appeal Board to the effect that Metropolitan did not oversee the management of these "white label" investments. On appeal, the Appeal Board held that the Registrar of Financial Services (currently the Prudential Authority) could not produce any evidence that suggested incomplete oversight in the management of these "white label" portfolios. What is of interest is that these portfolios were a method for introducing previously disadvantaged people in South Africa who did not necessarily have the skills as fund managers. The Registrar argued that these "white label" funds were therefore contrary to the public interest and the public should be protected from such investments.

In the Pension Funds Act, 1965, it is not a requirement for the board of directors/trustees of a pension fund to be educated or to be skilled investors and for this reason most trustees rely on the expertise of fund managers. However, the Registrar could have requested the aggregated losses or profits for all "white label" portfolios to ascertain whether reckless business investment practices had occurred. A few questions can be posed here, for example: How did Metropolitan manage the 154 fund managers? Did all the fund managers select the same listed shares? That would have made it very easy to oversee the investment decisions of each "white label" portfolio. Whatever the case, we were unable to find any relevant information in this regard. Lastly, and probably the most important question, how important was ESG to Metropolitan Collective Investment Schemes or to the "white label" fund managers?

King I in paragraph 9.2 of Chapter 20 is not specific on whether fund managers who rent licences are included in or subject to King I, nevertheless King I does require voluntary transparency and sustainability reports. To illustrate the importance of transparency, the following question can also be asked: How many pension funds would have made use of "white label" fund managers knowing that the fund manager had no relevant skills (or training) and very little to no investment expertise to invest their funds? Or did Metropolitan disclose all 154 fund managers (or their business names) in its financial statements or sustainability reports to make the investment public aware that Metropolitan was renting its licence to 154 unskilled entities? These questions remain unanswered. If one focuses on King I, as an example, the above information is part of transparency and any investor or pension fund would most likely rely on transparent information before making use of a "white label" fund manager.

In terms of in its new revised Equities Rules, Rule 3.60.1 (and Rule 4.50 for example), the JSE Ltd requires that any person who acts as a fund manager must be a fit and proper person; in other words, he or she has the necessary academic qualifications and approval from the Financial Services Conduct Authority (FSCA). Fund managers must also inform the Director of Market Regulation (JSE Ltd) of the type of shares they invest in on behalf of their clients (private individuals or pension funds). Therefore, the requirements are currently more stringent than they were 10 or 20 years ago when Metropolitan rented its fund manager licence to unskilled, uneducated fund managers (JSE Equity Rules, 2020, Rules 4.50 and 3.60.1). The consequences of these actions are probably still felt today, but we were unable to find any documented financial losses.

It is possible that written contracts could exist between pension funds and fund managers, explaining how the fund manager should invest only in ESG-compliant listed companies, and give feedback to the pension fund on their investments on a monthly basis. This contract is not required in the Pension Funds Act, 1965, and there is also no requirement that a written contract should exist between the employees of an employer and their pension fund, such as for requesting the pension fund to invest only in ESG-compliant companies on their behalf. It is possible, indeed advisable, to enter into both types of contracts between employees and the employers' pension fund as well as between the pension fund and its fund manager(s). It is also advisable to stipulate in the contract the right to receive feedback the moment an investment is no longer ESG compliant. In this regard, the contract must clearly stipulate the "remedies", for example the authority to sell those shares and to invest in another JSE listed company that complies with ESG (JSE Equity Rules, 2020, Rule 3.170). Since no written contract is required by the Pension Funds Act, a valid conclusion can be made that there is currently nothing that mandates (contractual) compliance with ESG.

b. No longer best in class or even benchmarking?

The moment one mentions nuclear power, one immediately thinks of Greenpeace (Greenpeace, 2021). Nuclear energy is considered unsafe, harmful to the environment, animals, plants and human beings. This is brought home by the well-known Chernobyl disaster. This disaster occurred nearly 35 years ago, and Chernobyl is still a no-go zone. The Russian response to this accident involved nearly 500 000 workers and cost US$ 68 billion to make Chernobyl "safe" again. South Africa has its own nuclear power station (the only one in Africa built in 1976) for generating electricity, the Koeberg Nuclear Power Station (Koeberg Nuclear Power Station, 2021; Deo, 2020). If one considers ESG, the environmental leg is relevant as any nuclear accident would cause long-term environmental harm – Chernobyl will not be habitable for up to 20 000 years. However, because we note that Eskom's business model focuses largely on fossil fuels to generate electricity for the citizens of South Africa, for example diesel and coal, we may conclude that the long-term sustainability of Eskom based on coal and diesel is problematic as it causes large-scale air pollution. In this regard, if coal or diesel is compared to nuclear power, nuclear power is a much cleaner form of energy, but accidents do happen as illustrated by Chernobyl. On the other hand, Koeberg had been in operation since 1976 without any major incidents. In this regard, something more is required than mere ESG disclosures. A good business model or plan and the ongoing successful implementation of that plan are required to promote environmental sustainability for Eskom in general and Koeberg in particular.

King IV requires a "compact strategy" or written contract between the government as a shareholder and Eskom as a state-owned company. In terms of this "compact strategy", Cabinet and the Executive Government of South Africa must decide on an appropriate business plan for Eskom to ensure not only the health of its citizens but also an increasing energy supply. An external auditor should review this "compact strategy" on an annual basis to see whether Eskom, as an example, is following and implementing this business plan appropriately (King IV 2016, p. 117).

To understand the business strategy of a particular company, ESG disclosures and a relevant transparent business plan (strategy) should be in place. This principle is not unusual since Eskom's "compact strategy/plan" discloses the importance of electricity price increases to maintain an appropriate balance between affordable electricity and the long-term financial sustainability of Eskom. To maintain this balance, transparent ESG disclosures are required. In addition, fossil fuels remain an environmental problem, and Cabinet and the Executive should consider Koeberg business plans for similar electricity generating plants in future to promote a long-term sustainability plan for South Africa, for example cleaner air as a result of nuclear power.

Koeberg is part of Eskom and Eskom contributes to its pension funds on behalf of their employees, for example the Eskom Pension and Provident Fund (EPPF). These pension funds – we assume – are making use of fund managers to invest in sustainable JSE listed companies. However, it will take time to convince the South African public of the best form of electricity in future is nuclear power. In this regard, ESG business plans (strategies) could be hampered by public opinion.

c. Instead, assessment by institutional investor and asset/fund manager of business model, product strategy, distribution system, research and design utilised and human resource policies of the company being analysed for good governance practices

One South African company, Woolworths Holding Limited (hereafter Woolworths), has explained its business plan in great detail in its sustainability reports (Woolworth's business plan, 2021). To understand how Woolworths is selling both its fresh produce and other products sustainably, Woolworths has explained its sustainable farming and other business practices in its report. Like Unilever discussed earlier, Woolworths is working with its suppliers (supply chain) to constantly redefine its business plan, not only to protect the environment, but also to create good social relationships with each supplier in the supply chain. Without a suitable business plan, the protection of the environment will not be realised, nor will the lives of all employees in the supply chain be improved. Woolworths' business plan is constantly being developed and reviewed to include more and more products that are produced sustainably, for example increasing the range of meat sold to the South African public and improving the shelf-life of dairy products and thereby changing the public opinion about sustainability. Woolworths has also explained that their business plan is negatively affected by the continuous land reform debate in South Africa, influencing its long-term vision for farmers in the Woolworths supply chain (Joubert, 2021). Therefore, even if ESG is managed successfully by Woolworths with a view to being a sustainable company in future, its business plan includes the uncertainties of land reform and the possible financial consequences this will have on the supply chain and/or shareholder value of its business. Should land reform occur, Woolworths is considering relevant farming technologies as a method to protect their shareholder value and turnover in the long term – less land, more products.

To be part of the Woolworths supply chain, a farmer must obtain at least a 65% pass rate in terms of the required farming methods/techniques introduced by Woolworths. Obviously the 65% pass rate is monitored by Woolworth's human resources department. Once passed, the farmer's products are worthy of a Woolworths logo associated with sustainability. Farmers and other entities in the supply chain are continuously observed/monitored by Woolworths (audit committee or human resources department) by setting new targets each year which they (farmers and other entities) must comply with.

It is evident that consumers who buy Woolworth's products are paying more for these products than competitors' products. However, it appears that consumers are willing to pay more for products that are sustainably produced, for example in terms of stable relationships between farmers and their employees, farming methods that protect the environment and the like (Woolworths Products, 2021). Paying more for a product helps Woolworths to bear the ever-increasing costs associated with sustainable farming, and their business plan or the business plan of the individual farmer in the supply chain, is simply to produce more food with less energy, with less water and with less land. This plan requires continuous assessment or review to obtain better sustainability results in future (Woolworths Products, 2021).

There is a close partnership between Woolworths and universities in the search for better methods for future farming (Woolworth Research, 2021). There is also a close relationship between Woolworths and the local communities that are producing the future farmers and farming employees, and experts measure the socioeconomic impact Woolworths has on these communities. Woolworths' human resources department is in regular contact with more than a thousand suppliers in its supply chain to understand their individual problems and needs. Woolworths has 45 000 employees and is continuously monitoring their employees' needs and providing training programmes and the like. These interventions are necessary to retain the 8 million South African customers who support sustainability and recognise the effects of non-sustainability. In addition, Woolworth's shareholders number (nearly) 60 000 in total, and they are in constant contact with Woolworths to understand the consequences of drought or land reform on the Woolworths business model and arrangements in this regard. It is also possible to waive dividend payments in order to improve the business model in any given year (Woolworth Research, 2021).

In this regard, ESG and a business plan are interdependent to produce sustainable future profits. Without an effective business plan (discussed earlier pertaining to the functions of an audit committee and the human resources department), irrespective of ESG compliance, the company will fail as a business enterprise. For this reason, an effective business plan and the communication thereof should be rated higher than general ESG disclosures. To understand ESG disclosures, Woolworth's investors/shareholders are constantly made aware of the business plan and the company prides itself on answering all shareholder concerns via email or through other forms of communication. All of the above require an effective human resources department/audit committee to document all such interactions, for example employees who have received training, contracts with academic institutions, contracts with individual suppliers and the like. For an investor, these documented activities illustrate "automatic" compliance and recognition of the importance of ESG, since all of these Woolworths contracts aim to improve social relationships, the environment and effective corporate governance – not only for Woolworths but for every enterprise in the supply chain.

As investors, pension funds/fund managers have access to all relevant reports on the Woolworths website (Woolworths Reports, 2021). It should be noted the GEPF is one of the major shareholders in this company as well as BlackRock fund managers (Woolworths Moneyweb, 2021). The mere fact that BlackRock invests in Woolworths shows that it understands the link between a good business plan and ESG disclosures. Although BlackRock is a US fund manager (with a branch in South Africa), its share price increased from US$ 62 per share in 2005 to US$ 414 in 2017 with more than 14 900 employees. It is therefore fair to assume that BlackRock considers ESG investments holistically, that is, ESG disclosures and an understandable (and implemented) business plan/strategy by the invested company as the "formula" for sustainable success (Blackrock, 2021)

Strengths and Weaknesses of ESG Investment in the City

One of the greatest obstacles pension fund managers have in choosing which companies to invest in is 'greenwashing'. A metric assessment based on 'tick box' questionnaires by company members will never expose greenwashing. This is a practice whereby company brands, either deliberately or unintentionally are exaggerating or misrepresenting the nature of ESG efforts to attract investors such as pension fund managers.

A study in 2020 by the European Commission into greenwashing practices examined 344 claims by companies that they were ESG compliant. In over half the cases there was insufficient information to judge the claim's accuracy while in 37 per cent of cases terminology used such as eco-friendly did not mean in reality there were no negative effects of the product for the environment. In 59 per cent of the cases reviewed companies claiming to practice ESG could not provide readily accessible evidence to support this assertion.

Overall, in 42 per cent of cases the authorities found reasons to believe that ESG claims were most likely false and deceptive, amounting to unfair commercial practice under the Unfair Commercial Practices Directive. (European Commission, Brussels, 28 January 2021).

To minimise the risks of greenwashing, fund managers need to review related regulation and investigate all green claims thoroughly with or without legal counsel. This can be done through an audit committee or a dedicated part of the human resources department.

On 7 July 2021 the Financial Conduct Authority (FCA) introduced a proposal for UK asset managers, FCA regulated for pension providers and life insurers a climate related disclosure regime. This new regime which is similar in nature to the European Union's Sustainability Finance Disclosures Regulation (SFDR) will strengthen ESG regulation. At present, the UK focusses only on climate -related disclosure while the EU includes social and governance considerations but the FCA are currently compiling a new 'ESG Sourcebook' which will comprise the FCA's source for rules and guidance on ESG topics. The FCA will focus on disclosure to try to influence investors to commit their capital to projects and companies that genuinely address climate change. The FCA intends that its regime is consistent with The Financial Stability Board's Task Force on Climate-related Financial Disclosure (TCFD) recommendations for both asset managers and asset owners. This is an international initiative for both companies and investors to disclose a set of climate-related information. (FCA Consultation Paper CP21/17** June 2021)

The EU Commission and UK are further assisting pension fund managers to choose the most ESG compliant companies to invest in. This is through the Carbon Border Tax confirmed on 14 July 2021 that will impose tariffs on imports from countries that are not committing to targets to reduce their reliance on fossil fuels and other carbon emitting products. The EU has also signed into law that it will become carbon neutral by 2050. Brussels has also committed to law in June 2021, to further reduce its carbon emissions by 55 per cent from 1990s levels by 2030. The UK has pledged to go even further by reducing carbon emissions by 68 per cent in the same timeframe. This is significant as the UK will host in November 2021 the COP-26 (international climate change summit) assuming a global leadership role.

The EU and UK proposals would affect almost every industry and be far reaching such as legislating that 35.8 per cent of all energy comes from renewables by 2030, ending the sale of petrol and diesel cars by 2035 and financially assist those most affected by these legal measures to reduce carbon emissions.

The cross - border carbon tax saw U.S. Congressional Democrats follow suit on 14 July with a proposed ‘polluter import tax’. (Sengupta, *The New York Times*, 13 July 2021; Erlanger and Sengupta, *The New York Times*, 14-15 July 2021).

It is not the first time that European countries have been effective leaders in exporting their environmentally friendly practices to neighbouring countries. The practice of recycling products such as packaging was exported to the UK from Germany in the 1950s.

Germany has recently moved forward to reduce carbon emissions by reducing meat eating along with the UK that has established vegan “butchers” in many major cities.

Therefore, finding ESG integrated companies to invest in will become even easier when climate compliance lists can be found through those companies not being charged the border carbon tax. (Germany Cow Retirement Home, 2021)

Risks, Barriers and Drivers of ESG Investment

As mentioned, the Securities and Exchange Commission (SEC) is a very effective regulatory body that both monitors and creates legislation to address any risk and malpractice in the Asset Management Industry in the U.S. The City of London asset managers also take note of SEC Risk Alerts and regulations.

On 9 April 2021 the SEC Board of Examinations issued a Risk Alert concerning registered investment companies, investment advisers and private fund managers who are involved with ESG services and products. With the upsurge in take up of ESG offerings, the SEC has noticed problems in standards of conduct. This had led to an unprecedented focus by the SEC on ESG practices. The SEC does not intend to create a new procedural framework for examination but to examine practices within existing disclosure and fiduciary frameworks.

The findings of the Risk Alert are illuminating concentrating on global problems and best practices of ESG asset managers.

The SEC examiners noticed that with portfolio managers their practices were inconsistent with ESG disclosures such as a company claiming adherence to a global ESG framework like UNPRI (UN Principles for Responsible Investment) while not meeting such standards.

They found that there were weaknesses in procedures and policies governing the implementation and monitoring of funds' ESG related directives. An example of this is that advisers do not control adequately their clients' positive screens such as preferences for certain issuers or industries or conversely negative screens such as prohibitions on investments in particular industries.

Also found were misleading or unsubstantiated claims such as concerning ESG approaches. Lack of clarity of marketing materials has been dealt with above but could also include omitting material facts impacting ESG investment performance such as expense reimbursements from ESG fund sponsors that inflate returns.

The SEC examiners observed that some advisers claimed to have contributed to the development of particular ESG products while in reality contributed very little.

Finally, they found that compliance programmes did not substantially address relevant ESG issues. Examples include companies that while claiming to adhere to ESG frameworks in fact do not address the frameworks in their compliance programmes, those that do not have policies and procedures in place to give reasonable support to ESG-related marketing claims and those with inadequate policies concerning oversight of ESG-focused sub-advisers.

The Risk Alert of the SEC also pointed to a number of best practices of ESG issues within asset management. These included;

1. Clear, precise disclosures bespoke for companies' specific approaches to ESG investing that are parallel to the firms' actual practices.
2. Procedures and policies that address ESG investing and that cover key aspects of the companies' actual practices.
3. Knowledgeable compliance personnel who understand the companies particular ESG - related practices.

(SEC Division of Examiners Issues ESG Risk Alert, 9 April 2021)

There are two broad drivers of ESG that are becoming increasingly urgent. One is climate change and the need for companies to be as energy efficient as possible. The other is the digital revolution with the internet of things taking prime place.

The world's largest lighting company Signify has been adhering to ESG principles since its spin out from Philips in 2016 through using 100 per cent renewable energy. Its products are fully recyclable and Signify supports its supply chain to reduce their carbon footprints. However, it is only now with the emphasis on the urgency of climate change and all companies wishing to reduce their carbon emissions, often with government aid, is energy efficiency becoming a major driver of company growth. Signify has a 3 per cent dividend yield. It is also a company of the digital age concentrating on smart interconnected LED lighting. (Moulds, *The Times*, 12 May 2021)

Another company, PTC, which is listed on Nasdaq, produces software designs that allow companies with maximum efficiency to test their products before spending on an actual prototype. The driver for rapid growth of PTC lies with its development of internet of things and augmented reality. These new technology processes allow manufacturers to gather data on how all their products are performing to maximise efficiency. PTC has also become more adept at managing customers' expectations which is key to retaining reputation and ESG principles of being transparent. (Moulds, *The Times*, 19 May 2021)

It may be seen in the City of London that especially with the shocks of the COVID pandemic and climate catastrophes such as wildfires, extraordinary heat waves and even recent flooding in central London with streets being submerged, there are very few antagonists to pension funds investing in companies that are operated under fully functioning ESG principles. The pension fund manager that does not adhere to this is now the outlier.

Strengths and Weaknesses of ESG Investment in South Africa

Although the board of directors may make use of a human resources department, as well as an audit committee to implement corporate governance practices or even to understand whether the company complies with its business plan (strategy), shareholder activism may require a different result (Kraik, 2020). Shareholders (e.g. pension funds that bought shares in a particular company), unlike company directors, do not have any fiduciary duties towards the invested company – there is no duty to act in the best interest of that company. Therefore, a shareholder may buy shares today and sell them a year later, but the implications of a certain vote exercised by that shareholder at an appropriate meeting of shareholders could continue long after the shareholder has sold his shares (King IV, pp. 32). A practical example could be the following. In the event the memorandum of incorporation of a company requires the board of directors to recommend a dividend, subject to a condition as to why a dividend should not be paid, and the shareholders declare the dividend – thus ignoring the condition – money or capital will flow out of that company. This money could have been used to further social relationships, for example to train key partners in the supply chain. For practical reasons therefore, shareholders must take note of the contents and economic effects of a vote when voting for or against dividends (Cohen, 2021).

On the other hand, South Africa's Companies Act 71, 2008, enforces the principle of good corporate governance, and it is possible to argue breach of care, skill and diligence in the event a company (irrespective of whether it is a state or government-owned company) or its board of directors refuses to implement or follow an approved business strategy or plan (King IV pp. 32). The Companies Act, 2008, allows the disqualification of directors for breach of their statutory duties (care, skill etc.) by declaring directors delinquents. Therefore, although King IV is a voluntary compliance document, it could be mandatory if so regulated in the company's memorandum of incorporation (Cohen, 2021). The memorandum is a contract between shareholders and the company, and between directors and the company. Therefore, ESG disclosures in either the financial statements or sustainability reports could be mandatory disclosures as a direct result of the memorandum (Kilian, 2007). The same applies to the business plans (strategies) required by the memorandum and the revision of those plans (strategies) annually, placing an obligation on the board of directors to keep in mind relevant ESG principles. The same conclusion can be reached between a pension fund and a fund manager, whereby the investment decisions or good corporate behaviour expected of a fund manager is regulated in a particular contract, as discussed earlier (Clacher, 2015*)*.

The government also plays an important role in enforcing ESG. For example, as long as Eskom uses fossil fuels to generate electricity, it may be penalised for not changing its business strategy to one of sustainability, for example, nuclear power.

To make sure that the human resources department and/or audit committee understands the relevant business plan (strategy) documents, it is advisable to appoint a compliance officer. The sole purpose of the compliance officer is to know the content of these documents, and to ensure that actual compliance occurs in practice. If not, the officer should inform the board of directors, audit committee and or human resources department of non-compliance (Cohen, 2021).

a. What are the barriers to ESG investment?

Pension funds and fund managers, as discussed earlier, must be able to read the business strategy of a listed company and relevant ESG disclosures to understand whether the company will actually be sustainable in future or not (Clacher, 2015*)*. Pension funds/fund managers should read additional material (news, articles etc.) explaining the market problems associated with that company, and how the board of directors is addressing such problems through an appropriate business strategy (Cohen, 2021). Without a suitable strategy – even if the company fully discloses ESG – it will not be sustainable. Implementing a sustainable business strategy may be so disruptive to the current business plan, that temporary financial losses could be incurred, but true investors or pension funds would understand that this is only in the short term. This belief or confidence in the ability of the business to succeed in the future cannot be explained in a single article (Cohen, 2021). If pension funds and or fund managers have no confidence in the business strategy then the following situation may arise, as observed by Arthur Levitt, the former Chairperson of the US Securities and Exchange Commission (King II, 2002, par.16):

> 'If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that

> country regardless of how steadfast a particular company's practices may be suffer the consequences. Markets must now honour what they perhaps, too often, have failed to recognise. Markets exist by the grace of investors. And it is today's more empowered investors that will determine which companies and which markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors' capital.'

A well-drafted business strategy will disclose the daily involvement of the board of directors in the listed company's business operations – a hands-on approach for considering and approving relevant transactions, processes and documents to be drafted by the audit committee (or legal issues in conjunction with the legal department) – as well as the relevance of the human resources department in disclosing the business strategy in financial statements or sustainability reports, as discussed earlier. Professor Mervyn King states the following (King II, 2002, par 6):

> 'The inclusive approach requires that the purpose of the company be *defined*, and the values by which the company will carry on its daily life should be *identified* and *communicated* to all stakeholders. The stakeholders relevant to the company's business should also be identified. These three factors must be combined in developing the strategies to achieve the company's goals. The relationship between the company and its stakeholders should be mutually beneficial. A wealth of evidence has established that this inclusive approach is the way to create sustained business success and steady, long-term growth in shareowner value.'

It is interesting to note that this daily involvement was implemented by Santam/Sanlam in the form of "Dagelijks Bestuur" more than a hundred years ago. When drafting the sustainability report or relevant ESG disclosures in financial statements or otherwise, directors should always ask themselves the question of whether pension funds/fund managers will find their explanations useful. There must be full disclosure (Woolworths Reports, 2021). Pension funds/fund managers who study these reports are looking for the actual implementation of that strategy or business plan (Woolworths Products, 2021). However, not all pension funds/fund managers view such explanations as relevant or important, as some are still focusing only on financial results (and/or share price) or dividends to be received, irrespective of whether the listed company is invested in, protects or destroys social relationships for example (Cohen, 2021). Professor Mervyn King states the following which is relevant to conclude this paragraph on ESG barriers (King II, 2002, par 8):

> 'Tomorrow's Company in the United Kingdom developed the concept of three corporate sins, namely *sloth*, being a loss of flair when enterprise gives way to administration; *greed*, when executives might make a short-term decision because it has greater impact on their share options and bonuses than a decision that might create longer term prosperity for the company; and *fear*, where executives become subservient to investors and ignore the drive for sustainability and enterprise.'

b. What are the facilitators or drivers of ESG investment?

The Institute of Directors in South Africa has commissioned four King reports in South Africa. This is the main driver explaining the relevance of ESG and why it is important to focus on ESG in the present. These documents are also supported by recent international developments to protect the planet, for example the Paris Treaty on Climate Change (Paris Treaty Website, 2021). In brief, this treaty fosters economic and social change for every state (196 signatories). For this reason, listed or unlisted companies that are unwilling to adopt new sustainable business strategies will be increasing penalised by their domestic states in order to achieve the climate change goal for each country set by this treaty. If a state is unwilling to penalise its domestic companies, it will be accountable to the "Global Stocktake" which assesses each state's progress or compliance with the Paris Treaty. The penalties, monetary or otherwise, to be issued may be severe, since the Paris Treaty aims for zero carbon emissions by 2030. For example, states may tax individual ownership of vehicles at a high rate in order to force owners to abandon the idea of owning vehicles that use fossil fuel. In future, pension funds/fund managers must take note of these implications when deciding whether to invest in motor vehicle companies that are unwilling to implement sustainable business strategies, as an example.

Human rights drive ESG investments – the quality of air, for example. In future, companies that abuse human rights will not attract investments. For this reason, the employee turnover rate, as discussed earlier, is a clear indication of the way a company respects individual employee rights. Legislation that protects majority rights at the expense of minorities in a state will become more and more redundant. For example, the Corporate Duty of Vigilance of France 2017 requires all subsidiary companies of a holding company situated in France to avoid any form of racial discrimination (Cossart, 2019). If a subsidiary conducting business in a foreign state is abusing human rights, the holding company in France may be fined up to 30 million euros. From a South African perspective, pension funds/fund managers that are investing in subsidiaries must take note of these fines or penalties, as the possibility exists that the fund will suffer in the long term.

In addition, the "early" retirement of chief executive officers must be properly explained, since most listed companies refer to early retirement without supplying any reasons for this. This is not to imply that a person should serve as a CEO indefinitely – but a reason is required if he or she retires prematurely. In the Sanlam/Santam example, the South African government issued the Sanlam Act, 1954 to prevent directors from continuing indefinitely as directors. Although this Act is no longer relevant, it does help to show the fine balance between the reasons for directors retiring and the promotion of sustainability.

Who are the foremost proponents of ESG?

The JSE Ltd is Africa's biggest stock exchange. The JSE listing requirements for companies are regulated by the JSE Limited Listing Requirements document (JSE Requirements, 2019). This document acknowledges the role of the King Report on Good Corporate Governance, but is more concerned with the remuneration of directors and their appointment as part of mandatory good corporate governance practices, as explained by this document (JSE Requirements, 2019, paras 3.84, 4.8, 8.63). On 27 June 2013, the JSE issued a guidance letter pertaining to integrated reporting, in other words reporting on ESG either in the financial statements or the sustainability reports. The JSE letter reads as follows (JSE Requirements, 2019 under the heading general administrative issues):

> 'Guidance Letter: Integrated reporting
> Date: 27 June 2013
> This letter aims to clarify … Integrated Reporting and disclosure is not a mandatory principle pursuant to our recent guidance and can therefore be applied on an “apply or explain

> basis"… [i]n conclusion, the JSE wishes to advise … the production of an Integrated Report is not a mandatory principle ...'

From this letter, it is clear that the JSE Ltd is not a proponent of integrated reporting, in other words, ESG disclosures. This is unfortunate. A business plan or strategy is only (as it seems) relevant to those companies that seek to list on the AltX –the alternative listing exchange of the JSE (JSE Requirements, 2019). To list on the AltX an applicant must submit a business plan (strategy). Once approval has been given, the entity will be listed (JSE Requirements, 2019 under the heading general administrative issues). Ongoing revision of a listed company's business plan (strategy) is also not required by the JSE, probably because it considers such an approach to be common business sense. Nevertheless, the importance of ESG and how it relates to a business plan (strategy) should be considered with a view to explaining the future sustainability of that company.

Lately, the JSE is starting to recognise the importance of ESG disclosures and integrated reporting on its website (JSE Website, 2021). Here, the JSE acknowledges and is a signatory to the United Nations Principles for Responsible Investment. It is also a founding member of the Sustainable Stock Exchange Initiative (Sustainable Stock Exchange, 2021). However, on the Sustainable Stock Exchange website, the JSE Ltd discloses only certain mandatory corporate governance principles, for example the appointment of directors and the like, as discussed earlier, and integrated reporting remains a comply or explain exercise. In other words, in the event of non-compliance the listed company must explain why it did not disclose ESG in full. The JSE states the following on the Sustainable Stock Exchange website (Sustainable Stock Exchange, 2021):

	Yes
ESG reporting required as a listing rule	• Requires (on an apply and explain basis) that listed companies annually report the extent to which they comply with the King Code. King IV includes sustainability reporting as well as integrated reporting.

- JSE also has mandatory governance disclosure requirements beyond the principles of King.

From the above, we may assume that the letter dated 27 June 2013 is still the main promoter explaining the JSE's commitment to "force" its members (listed companies) to disclose ESG.

Value considerations-intangible assets

The majority of assessments concerning the principles of ESG being adhered to are based on tangible assets. Metric assessment always relies on attributing numeric value to determine compliance. This a flawed form of analysis in relation to principles of ESG being exercised as intangible assets are often the best indicators of such success. This is especially true in the digital age where website services, especially run by tech giants, are predicated on intangible assets which include, strategic positioning with customers and exceptional management. Intellectual Property (IP) such as brand, copyright, industrial design, patents and trade secrets, which are the company products that deal in digital age goods and services. The internet of things (IOT) for example, is a prime process that supports efficiency with minimum waste that is an intangible asset. The interconnectivity of IOT data collection through sensors, for example, can detect accurately carbon emissions and how well they are being controlled.

This becomes a serious problem for pension fund managers who are determining the veracity of companies adhering to ESG principles. This is because tangibles appear on the balance sheet with only any depreciation charge entering the profit and loss account. It can be the case then, that there will be no impact on cashflow after the tangible purchase.

In the case of intangible assets spending, it is channelled through profit, loss account and cashflow. Most software is not capitalised nor is research and design or brand development. This means that the profitability on the balance sheet in relation to intangible assets is depressed vis a vis a company buying a tangible asset such as a piece of machinery. Therefore, it becomes impossible to simply compare the company’s price - to -earnings ratio.

This is an essential problem for both accountants advising pension fund managers who cannot see on the balance sheets internally generated intangible assets. It also presents a great challenge to pension fund managers and shareholders making investments who cannot determine the true worth of companies where value is largely generated by intangible assets. Traditional metrics do not work, especially with large tech and technology driven innovative companies, leaving investors unsure of the true value of shares from ESG compliance. (King, *The Times*, 15 April 2021; Taplin, 2013)

Value considerations- How do we define both financial and non-financial value when assessing the use of ESG as an ethical good governance tool?

Defining financial and non-financial value in terms of ESG may be regarded as problematic, as ESG deals with companies' future sustainability. In other words, if a company protects the environment or its social relations then we may assume that it will be more sustainable in the long term and as a consequence more profitable. Thus, ESG deals with non-financial indicators (for example social relations) and we may assume that the disclosure of these indicators would contribute positively to the financial indicators, for example profits. However, there are certain companies that, owing to the nature of their business, will never be able to comply with sustainability, for example the producers of fossil fuel. Although such companies have been profitable in the past 100 years or so, in order to protect the environment in future it is probably not advisable for pension funds or fund managers to invest in them. In the case of electricity generation, for example, the world is seeking alternatives in order to protect the environment in future. In this regard, in future company profits or company value will depend among other things on how companies are managing the environment and how they disclose ESG as part of their management principles. We may assume that companies that manage the environment more successfully will have a higher ESG score than those that damage the environment or whose social relations are fractured. In this regard, a close link exists between financial and non-financial indicators when defining company value. However, ESG disclosures can be flawed. In a recent article it emerged that the more ESG information a company discloses, the more likely ESG rating enterprises (for example fund managers or pension funds or independent rating agencies) are to disagree with how well that company is performing (Senz, 2021). Not all ESG rating enterprises appreciate or attach significant value to non-financial disclosures in the same way. While some appreciate full disclosure when current profitability or future profitability is explained, others do not value such disclosure, as rating enterprises interpret and process full disclosures differently. This failure to appreciate full disclosure may affect pension funds or fund managers in their investment decisions and could result in less investments in a particular listed company, resulting in financial harm to both the company itself and the pension funds or fund managers. A practical example would be Conduit Capital, a JSE-listed company which owns Constantia Insurance. Recently, Constantia started showing profits as a result of a business restructuring process. Is this information/disclosure regarding the restructuring sufficient to explain the future sustainability of Constantia? Or, if it were to be explained that the restructuring is the result of employee dismissals, would such a disclosure be considered more useful? Which one of the two disclosures defines the financial value of Constantia? And which explains the future sustainability of Constantia? The problem is that nobody really understands disclosures or how to assign value to them (Conduit Capital Business Restructure, 2021; no explanation is given to explain the business restructuring at Constantia Insurance). Until such time that ESG is formally regulated it will be very difficult to attach future financial value to a company on the basis of unregulated ESG disclosures.

Recommendations

On the basis of this Report, we would like to make the following recommendations.

1. As pension fund managers bear a good deal of the weight of responsibility for choosing which portfolios, companies to invest in, they must be chosen carefully. Cases of cronyism, choices made on the basis of identity or other political considerations other than merit need to be avoided. This means a deep understanding, commitment and passion associated with social good, ethical corporate governance and environmental issues.
2. To facilitate a working knowledge of ESG and how to work the complex applications of what companies need to do to be fully compliant and integrated with ESG in their everyday practices, a training course should be mandatory. This could be an accredited training course operated by the Institute of Directors which has a branch in South Africa. Training courses should be offered to fund managers and their teams as well.

3. Further research needs to be undertaken exploring how to calculate the real value of intangible assets in relation to understanding the worth of ESG investment.
4. The possibility exists that pension funds or fund managers (or independent rating agencies) do not consider disclosures in the same way. For this reason, ESG disclosures should be effectively regulated in future to prevent inconsistencies when interpreting such information.
5. ESG disclosures should be regulated in so-called hard law rather than soft law. Hard law would prevent pension funds or fund managers from interpreting disclosures differently We may define hard law in terms of legislation such as the Companies Act which is mandatory, while soft law would be a voluntary compliance document such as the aforementioned King Report in South Africa. ESG disclosures would be best regulated in relevant legislation.
6. Further research is needed to understand when disclosures are adequate in relation to investment decisions. This would also assist pension funds when attempting to assess the extent of a listed company’s ESG compliance.
7. An annual course for fund managers and their team to update their knowledge concerning new ESG related regulation and rapidly changing legislation and landscape of, for example, environmental issues. Workshops and seminars to this effect would also be useful.
8. The use of integrated technologies such as IOT and satellites need to be further developed to facilitate comprehensive data collection to increase efficient and transparent understanding of ESG integration in all industries.

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