Importance of 'G' in ESG and what happens when governance fails in the TMT sector

Environmental, social and governance (ESG) has transformed from a "nice to have" buzzword to a "must-have" demonstrable compliance requirement. As such, ESG is now also widely accepted as an important tool for a business to not only achieve or drive impactful sustainable development but also to strive for long-term value creation that strengthens and does not hamper the environment and the broader society in which the business operates. ESG is also geared towards making sure that every business understands and engages with the broader societal concerns of its day-to-day operations, mainly targeted at non-financial metrics.

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ESG litigation

As ESG continues to grow in importance, however, the number of ESG litigation matters could become self-perpetuating. It is, therefore, necessary to navigate the risks and the impact of ESG, in particular, governance in the technology, media, and telecommunications (TMT) sector, which, more than ever, is seeing greater involvement of regulated financial institutions that sit within TMT groups.

“Often, little consideration is given to the ‘G’ in ESG, but significant consequences may arise from failures in governance, specifically by the board of directors and senior management of financial services providers (FSPs) within the TMT space. South Africa has a heavily regulated financial services sector, which means that financial institutions are under greater scrutiny and with the surging interest in ESG, it is important for financial institutions and their partners such as telcos and fintechs, to be cognisant of governance requirements,” says Gabi Richards-Smith, a partner in Webber Wentzel's financial services team.

Analisa Ndebele, an associate in the same team, agrees that governance is an essential pillar of ESG that should not be overlooked, as it truly affects how the environmental and social pillars are implemented. “As part of the growing popularity of ESG, there is an increased focus on the global sustainability and development agenda (such as climate change and net zero), as well as a renewed drive towards sustainable development and corporate social responsibility, with businesses recognising the importance of diversity and promoting inclusion, which all is fundamental to the “S” in ESG. However, there seems to be a lesser focus on governance, specifically with financial institutions coming under greater scrutiny,” highlights Ndebele.

Governance unpacked

“Governance needs to be a primary consideration when businesses establish and implement their ESG frameworks,” states Ndebele. Generally, there is not one specific definition for governance, but it refers to how a company is managed, including its leadership structure, its internal systems, and controls, as well as the rights that shareholders hold.

Ndebele says that considerations that would fall under governance could involve anything from compliance with regulatory law to the risk management of the company, how the company engages with stakeholders, any reputational mitigation, and risks that it undertakes, as well as its monitoring, disclosures, and reporting procedures.

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“The board of directors, and to some degree the senior management of a company, carries this governance responsibility, but if they are not aware of it or if the company does not have an appropriate governance framework in place, or that it has not established the necessary operational systems to ensure implementation of and compliance with such governance framework, then these individuals would be liable for any failures and would be deemed to have breached a whole host of duties found in both common law and legislation, more specifically for FSPs,” cautions Ndebele.

Richards-Smith adds that directors owe a fiduciary duty to the company and some of these duties are codified (as in the Companies Act, the King Code, and other financial services legislation), with other duties also evolving in common law. “In the ESG era, directors are, however, also forced to consider prevailing market sentiment when discharging their fiduciary duties. This is mainly from a reputational perspective, given the increased scrutiny that these businesses are under.”

Practical governance in the TMT sector

Lenee Green, a partner in Webber Wentzel's financial services team, points out that not only directors have fiduciary duties and that a fiduciary relationship can arise where there are certain elements present, for example, in the TMT sector, considering that it often overlaps with the financial services sector, as there are often FSPs or companies that also render financial services for certain products.

To address the complexities around the practical implementation of the ESG regulatory framework and specifically with reference to the relationships toward other parties or employees within a company, Green suggests the following:

- Bear in mind: the acts of the company, the services that they are rendering to their customers, whether these services are regulated, and in what relationships and contractual relationships are present.
- An employee will always stand in a fiduciary duty towards their employer.
- A common law conflict of interest arises in circumstances where one person stands in a fiduciary relationship towards another person.
- This relationship may arise through various sources, including but not limited to contractual relationships.
- When does a person have a fiduciary duty and how can a conflict of interest arise? An individual can act as an agent on behalf of a client of the company (as its principal), the individual might be standing in a fiduciary relationship towards the client (as principal). The elements to assess if a fiduciary relationship exists are set out in the Philips vs Fieldstone case, namely (i) a scope for the existence of some discretion of power, (ii) the power or discretion can be used unilaterally to affect the beneficiary's legal or practical interest, and (iii) there is a vulnerability to the exercise of that discretion or power.
- Therefore, determine if there is a fiduciary relationship that exists, then examine the duties imposed on that individual/agent acting on behalf of a client (as principal). If there is a conflict between the duties and a personal interest of that individual (acting as an agent on behalf of a client/principal), then it might be that the individual is acting in breach of its fiduciary duty.

“If the agent standing in a fiduciary duty is aware of the conflict of interest but is making a secret profit from rendering a duty on behalf of the principal, that profit would automatically accrue to the principal, who may claim disgorgement of those profits. So, there are two important aspects involved to effectively manage the conflict from a governance perspective: the agent needs to disclose if any secret profit is made and needs to get a waiver from that client to essentially waive its rights to those profits, and consent to the agent earning the profit,” explains Green.

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Prescriptive laws

Ndebele says that South African financial sector laws are very prescriptive when it comes to potential or actual conflicts of interest. This is particularly relevant when there is a relationship between an FSP and a third party, like the product supplier of a financial product.

“In this instance, the remuneration that can be earned is limited to what is prescribed in the Financial Advisory and Intermediary Services Act, as well as the General Code of Conduct for Authorised FSPs. Specifically in the General Code, a conflict of interest includes the receipt of any remuneration by that FSP, which prevents or could potentially prevent that FSP from rendering an unbiased and a fair service to its clients. Or it could prevent the FSP from acting in the best interest of its clients, and in that sense, the General Code is broader than the common law principles.

"It specifically requires that any financial interest that is paid to an FSP, needs to fit into one of the allowed categories that are provided for in the closed list in the General Code. Generally, this could include commission, fees or other remuneration that is prescribed under the statute to which that FSP is entitled. Alternatively, the remuneration would need to be reasonably commensurate with the services that the FSP has rendered to the third party. Whether the fees can be said to be reasonably commensurate is a factual inquiry,” elaborates Ndebele.

“If a financial interest is received and it does not meet either of those closed list of categories in the General Code, then that financial interest is going to be deemed unlawful because it is in contravention with the provisions of the General Code and serious penalties could arise. So, if you consider FSPs specifically, you need to be aware of the possible consequences from failures in governance.”

Governance stands as an essential pillar of ESG that must be proactively integrated into the day-to-day activities of companies, particularly within the ever-evolving TMT sector. To mitigate the far-reaching consequences that may arise, we must adopt a comprehensive governance framework capable of addressing the intricate nuances of this industry. Let these insights serve as a call to action for companies to prioritise governance as a means to drive responsible growth, sustainable success, and positive societal contributions in our continually changing business landscape.