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BUSINESS OWNERSHIP IN SOUTH AFRICA

Why Black Empowerment Transactions are necessary, the Blurry Line of Fronting & Other Challenges

ABSTRACT

Analysis of empowerment laws with focus on the BBBEE Act, breakdown of ownership and development targets and their importance, explanation on PPPFA and BBBEE licensing requirements, functions of the Commission, assessment of the crime of fronting.

* Empowerment laws are subject to change.
** This document does not constitute advice.

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1. INTRODUCTION

The implementation of black economic empowerment transactions in South Africa is becoming increasingly necessary for businesses to survive and the legal issues around these transactions are accordingly of considerable importance to many people.

What follows is a summary of key features of the applicable legislation, the Broad Based Black Economic Empowerment Act 53 of 2003 (the "**BBBEE Act**"). An overview of the empowerment rating system is provided. This is followed by an analysis of how prescribed empowerment targets relating to (a) ownership and (b) enterprise and supplier development, either compel or influence businesses to enter into empowerment transactions.

In a less detailed manner, the impact of the Preferential Procurement Policy Framework Act 5 of 2000 ("**PPPFA**"), which provides for a system of rewarding empowerment credentials in the allocation of state tenders, is explained. The importance of empowerment to the allocation of licenses is also considered. With the challenges in context, important functions and powers of the recently established regulatory body responsible for overseeing the implementation of the BBBEE Act, the Broad Based Black Economic Empowerment Commission (the "**Commission**"), are highlighted.

The crime of fronting is assessed with reference to case law. Important factors which are relevant to whether a relationship might be considered as fronting are identified. An overall picture of the reach and complexities of Empowerment Law is provided to emphasise the importance of carefully considering the details of empowerment transactions.[1]

2. BBBEE RATINGS

The BBBEE Act is the key legislation for black empowerment in South Africa. Other notable legislation includes the PPPFA and the Employment Equity Act 55 of 1998.[2]

TABLE 1: NOTABLE LEGISLATION

LEGISLATION	IMPACT
BBBEEE	Creates the legislative foundation for black empowerment scoring criteria and the issue of empowerment ratings.
PPPFA	Allows black empowerment ratings (and how they are achieved) to be relevant, and in some cases necessary, to enter into contracts with organs of state.
Employment Equity Act	Requires employers to implement employment equity plans which must include appropriate affirmative action measures with reference to demographics.[3]

[1] Effort has been made to make the content detailed and manageable to digest at the same time. There are though a great deal of empowerment laws, policies and considerations not covered. Advice should be sought in any given transaction.
[2] For a summary of legislation relevant to black empowerment prior to the BBBEE Act coming into effect see FLEISER L, "What is a Black Economic Enterprise?" Juta Business Law, 2001, Volume 9, Part 1, p22.
[3] The related statistics, published by Statistics South Africa under section 42 of the Employment Equity Act also influence BBBEEE scoring elements. There are moving demographic targets.

One of the primary purposes of all empowerment legislation is to change the racial and gender composition of business in South Africa.[4] This includes ownership, control and the make-up of employees of businesses.

To achieve this, the Minister of Trade and Industry is given the power under the BBBEE Act to issue codes of good practice (the "**Codes**") which prescribe criteria to be assessed against for the issue of an empowerment rating.[5]

After being assessed and allocated points, all businesses, regardless of their size, are issued with a BBBEE status level based on a tiered scoring system. As set out in Table 2 below, the BBBEE Status levels allocated to a "**Measured Entity**" range from level 1 (best score) to level 8 and 'non-compliant' (lowest score).[6]

TABLE 2: BBBEE LEVELS

B-BBEE STATUS	POINTS ON THE GENERIC SCORECARD	RECOGNITION LEVEL
Level One	≥ 100 points	135%
Level Two	≥ 95 but < 100	125%
Level Three	≥ 90 but < 95	110%
Level Four	≥ 80 but < 90	100%
Level Five	≥ 75 but < 80	80%
Level Six	≥ 70 but < 75	60%
Level Seven	≥ 55 but < 70	50%
Level Eight	≥ 40 but < 55	10%
Non-compliant	< 40 points on the generic scorecard	0%

Each Measured Entity's BBBEE status level has a "**Recognition Level**" attached to it which is expressed as a percentage. When goods (or services) are purchased from a supplier the percentage attached to the supplier's Recognition Level is multiplied by the actual Rand cost of such goods to calculate a *deemed amount* of money spent.

This *deemed amount* is then allocated (by the purchaser) towards a prescribed empowerment target under the heading "**Preferential Procurement**". The idea is for business in general to 'prefer' when 'procuring' services, suppliers with Recognition Levels which add "empowerment value". This "empowerment value" comes about by making it possible for the purchaser to allocate a larger amount towards Preferential Procurement empowerment targets.

For example, in pursuit of a given target, R100 spent on a level one company will be deemed to be R135 (R100 multiplied by 135%) while R100 spent on a level seven company will be deemed to be R50 (R100 multiplied by 50%). Although both companies in this example charge the same price, the difference in empowerment value is R85.

[4] BBBEE Act, Objectives, Section 2 (a) and (b). There are several objectives but these two are primary.
[5] BBBEE Act, section 9. BBBEE Certificates can only be issued by verification agencies approved by the Department of Trade and Industry.
[6] There are presently no fines imposed for being 'non-compliant'.

All things being equal, customers of a business with a good Recognition Level will score more empowerment points than customers of a business with a bad Recognition Level. This is where some of the "broad based" part of the name of the BBBEE Act comes from, the focus not just being on ownership (direct empowerment) but also on facilitating the success of black business (indirect empowerment).[7]

3. AN OVERVIEW OF THE SCORING SYSTEM

The latest Codes[8] prescribe a system of rating an organisation's contribution to black[9] empowerment by allocating points to five elements being (1) ownership, (2) management control, (3) skills development, (4) enterprise and supplier development and (5) socio-economic development. A business will be measured against this scoring system unless it operates in a defined sector of the economy which is regulated by a "**Sector Code**".[10]

The points available for each element depend on the annual revenue of the business being assessed (the "**Measured Entity**"). Each element's scoring method is set out in a different chapter of the Codes, called a "**Statement**".

Table 3 below compares the points available for Measured Entities based on their annual revenue. It also refers to the relevant Statement for each element. "**QSE**" in the table means "Qualifying Small Enterprise" and "**EME**" means "Exempted Micro Enterprise".[11]

TABLE 3: OVERVIEW OF THE SCORING SYSTEM

<table>
<tr><th>ELEMENT</th><th>ANNUAL REVENUE OVER R50 MILLION - GENERIC SCORECARD</th><th>STATEMENT FOR LARGE ENTERPRISE</th><th>ANNUAL REVENUE R10 TO R50 MILLION - QSE SCORECARD</th><th>STATEMENT FOR QSE</th><th>ANNUAL REVENUE BELOW R10 MILLION - EME RULES</th></tr>
<tr><td>*Ownership</td><td>25</td><td>100</td><td>25</td><td>601</td><td rowspan="6">Only EMEs Automatically level 4.

EMEs & QSEs 100% black owned = automatically level 1.

51% black owned = automatically level 2.</td></tr>
<tr><td>Management Control</td><td>15</td><td>200</td><td>15</td><td>602</td></tr>
<tr><td>*Skills Development</td><td>20</td><td>300</td><td>25</td><td>603</td></tr>
<tr><td>*Enterprise and Supplier Development</td><td>40</td><td>400</td><td>30</td><td>604</td></tr>
<tr><td>Socio Economic Development</td><td>5</td><td>500</td><td>15</td><td>605</td></tr>
<tr><td>Points Available</td><td>105</td><td>N/A</td><td>110</td><td>N/A</td></tr>
<tr><td>Statement on Relevant Principles</td><td>N/A</td><td>000</td><td>N/A</td><td>600</td><td>000</td></tr>
</table>

[7] SCHNEIDERMAN D, "Promoting equality, black economic empowerment and the future of investment rules", SA Journal on Human Rights, 2009, Volume 25, Part 2, p246.
[8] GG36928 of 11 October 2013 as amended by GG38765 of 6 May 2015.
[9] The BBBEE Act defines "Black People" as a generic term which includes Africans, Coloureds and Indians.
[10] Amended Codes, Statement 003: Amended Guidelines for Developing and Gazetting Sector Codes.
[11] Provision is made in the Codes for start-up enterprises to be considered as EMEs in their first year.

As identified in Table 3, the Statement for measuring ownership for Measured Entities with an annual revenue over R50 million is Statement 100 and for a QSE it is Statement 601. The "**Generic Scorecard**" refers to the scorecard which applies to all entities apart from QSEs, EMEs and Measured Entities which operate (as mentioned) in specific industries or "sectors" and in respect of which a prescribed "**Sector Code**" applies.

One of several reasons it is easier to obtain a better empowerment level for a QSE is there are 110 points available, as opposed to 105 for Large Enterprises (these numbers exclude bonus points which are not apparent on the face of the scorecards). While different Statements and therefore different point allocation methods apply to QSEs, the total number of points earned is still tallied and a level allocated with reference to Table 2.[12]

Before examining any of these Statements, many principles will be apparent from the above table in so far as empowerment ratings are concerned. Some of these principles are listed below:

- It is not necessary for any EME or for a QSE which has a 51% black shareholding to be assessed against any of the Statements.[13]

- Different requirements apply based on revenue and some businesses may intentionally refrain from investing and/or growing to either avoid additional costs of being assessed or of achieving empowerment targets or both.

- EMEs and QSEs which are 100% black owned have an advantage because they will automatically be certified as level 1. It makes no difference in this respect if an EME or QSE has 99% black shareholders or less. If an EME or QSE is 99% black owned it can only be deemed a level 2 and not a level 1.

- EMEs and QSEs which are above 51% black owned have an advantage because they will automatically be certified as level 2. It makes no difference in this respect if an EME or QSE has 50% black shareholders or less. If an EME or QSE is 50% black owned it cannot be deemed to be a level 2.

- EMEs and QSEs which are 100% white owned, (assuming their ability to source work is impacted because of their ratings) will have to find a black majority shareholder if they want to automatically qualify as a level 2.

- EMEs and QSEs which have black shareholders who hold less than 100% or 51% respectively and need an improved rating to source work will also have to restructure. This would probably involve a minority black shareholder being issued with more shares, alternatively finding additional black shareholders to take up a white shareholder's shares.

- In some instances, it will be a challenge for black entrepreneurs to partner with white entrepreneurs because the value provided by the white partner, whether in the form of skills or capital must be weighed up against the cost to the proposed venture's empowerment level.

It will now be explained how the Statements on ownership compel larger businesses and QSEs to restructure.

[12] Statement 600, paragraph 3.3.
[13] An EME only needs to submit an affidavit confirming its revenue and black ownership. Statement 100, paragraph 4.

4. HOW OWNERSHIP TARGETS COMPEL EMPOWERMENT TRANSACTIONS

4.1 THE OWNERSHIP SCORE

Statement 100 for measuring the ownership element of the Generic Scorecard is set out in Table 4 below. The Statement for measuring the ownership element of QSE's is Statement 601. The two statements are both worth 25 points, but they have different point allocations for the sub-targets provided.

All statements break down the points available for an element into sub-targets or "**Indicators**" which are identified in the first column. This is followed by a description of what must be done to earn points in the second column, the available points in the third column and a "**Compliance Target**" in the fourth column.

TABLE 4: OWNERSHIP SCORECARD[14]

INDICATOR	DESCRIPTION	WEIGHTING POINTS	COMPLIANCE TARGET
2.1 Voting Rights	2.1.1 Exercisable Voting Rights in the Entity in the hands of **Black people**.	4	25% + 1 Vote[15]
	2.1.2 Exercisable Voting Rights in the Entity in the hands of **Black women**.	2	10%
2.2 Economic Interest	2.2.1 Economic Interest in the Entity to which **Black people** are entitled.	4	25%
	2.2.2 Economic Interest in the Entity to which **Black women** are entitled.	2	10%
	2.2.3 Economic Interest of any of the following Black natural people in the Measured Entity.		
	2.2.3.1 Black designated groups; 2.2.3.2 Black participants in Employee Share Ownership Programmes; 2.2.3.3 Black people in Broad-based Ownership Schemes; 2.2.3.4 Black participants in Co-operatives.	3	3%
	2.2.4 New Entrants	2	2%
2.3 **Realisation Points**	**2.3.1 Net Value**	**8**	**Refer to ANNEXE "E"**[16]

[14] Statement 100, paragraph 2.
[15] This means 25% plus an extra vote. It does not mean 26% but because this is the practical impact, often empowerment transactions involve the transfer of 26%.
[16] At time of writing there is an incorrect reference in the table contained in the Codes to "Annexure C".

The three Indicators under the ownership scorecard are “voting rights” (6 points), “economic interest” (11 points) and “**Realisation Points**” (8 points), all of which add up to a total of 25 points available for the ownership element of the Generic Scorecard.

It will be noticed that extra points are awarded when black women are allocated “voting rights”[17] or an “economic interest”[18] in a Measured Entity. In addition, extra points are allocated to other categories of persons including “New Entrants”. This term is not defined in the Codes but “Black New Entrant” (which is what is being referred to) is defined and refers to a new black shareholder who has never held equity instruments in other entities valued over a prescribed amount.[19]

4.2 THE PRIORITY ELEMENTS

Under the Codes there are three elements described as “**Priority Elements**”.

The Indicator called “Realisation Points” with the action described as “Net Value” in Table 4 above is in bold. This Indicator is one of the three Priority Elements.[20]

If prescribed targets relating to a Priority Element are not met then a Measured Entity’s empowerment level is penalised by being discounted by one level, regardless of what has been achieved in relation to other empowerment targets.

The transfer of a prescribed percentage of the ownership of a Measured Entity to black people (which is what Realisation Points deals with) is a Priority Element. This means that if a Measured Entity works hard to achieve a good empowerment level but does not transfer a prescribed minimum percentage of ownership to black people, its empowerment level will be discounted by one level.

There are three Priority Elements under the Codes which are set out in Table 5 below along with the prescribed targets and consequences for noncompliance.

[17] “Voting right” is defined as a voting right attached to an equity instrument. Schedule 1 to the Codes.
[18] “Economic interest” is defined as a claim against an entity representing a return of ownership similar in nature to a dividend right (in other words the right to receive dividends). Schedule 1 to the Codes.
[19] Schedule 1 to the Codes. The figure is currently R50 million.
[20] Statement 000, paragraph 3.3.

TABLE 5: PRIORITY ELEMENTS

PRIORITY ELEMENTS	TARGET IF ANNUAL REVENUE OVER R50 MILLION [LARGE ENTERPRISE]	TARGET IF ANNUAL REVENUE R10 TO R50 MILLION [QSE]
Ownership	40% of the 8 points available for Net Value	40% of the 8 points available for Net Value
Skills Development	40% of the 20 points available	40% of the 25 points available
Enterprise and Supplier Development[21]	40% for each of the three Indicators being: Preferential Procurement (25 points available) Supplier Development (10 points available) Enterprise Development (5 points available)	40% for each of the three Indicators being: Preferential Procurement (20 points available) Supplier Development (5 points available) Enterprise Development (5 points available)
Minimum Compliance	Must meet targets for all three Priority Elements.[22]	Must comply with the ownership Priority Element as well as one of the other two Priority Elements.[23]
Consequence for non-compliance	BBBEE empowerment level discounted by one level.	BBBEE empowerment level discounted by one level.

Focusing on the ownership element, it will be noted that both QSE and Large Enterprises must comply with the ownership Priority Element. What, though, does "40% of the 8 points available for Net Value" mean?

It will be explained further below that essentially what this means is that within a prescribed time frame, all Large Enterprises and QSE's must transfer 10% of their shares to black people and such shares must be 100% unencumbered, failing which their empowerment ratings will be discounted by one level.

Before explaining the scoring mechanism for the target relating to "Net Value", and how the above-mentioned time frame is regulated, the implications of the compliance targets set for the Indicators described as "**Voting Rights**" and "**Economic Interest**" in Table 4 are considered.

[21] Possible 'bonus points' are available but are not relevant for present purposes.
[22] Statement 000, paragraph 3.3.2.1.
[23] Statement 000, paragraph 3.3.2.2.

4.3 VOTING RIGHTS AND ECONOMIC INTEREST

The compliance target for black voting rights is 25% plus 1 vote (refer to Table 4).

Table 6 below explains how points are allocated to voting rights. Four entities are identified with different hypothetical shareholdings (and commensurate voting rights) held by black people generally and black women specifically. The points which are allocated are shown along with the total.

TABLE 6: VOTING POINTS

VOTING RIGHTS	ENTITY ONE	ENTITY TWO	ENTITY THREE	ENTITY FOUR
Held by black people Target - 25% [plus 1 vote]	10%	25% [plus one vote]	50%	85%
Points [max 4]	1.6	4	4	4
Held by black women Target 10%	10%	10%	0	0
Points [max 2]	2	2	0	0
Total Points on Voting	**3.6**	**6**	**4**	**4**

Applying the formula provided in Statement 100,[24] if a black shareholder controls 25% (plus one vote)[25] of the voting rights of a Measured Entity, then 100% of the Compliance Target is achieved ((25/25)100) and 100% of the available 4 points is awarded, which is 4 points. This is the case with entity two in Table 6.

The same formula applies to the points available for voting rights held by black women. In entity two 10% of the voting rights are held by black women. This is exactly the compliance target which is 10% and which accordingly results in all the *maximum available* points (2 points) being allocated.

As can be seen from the examples in Table 6, all other things being equal:

- A measured entity which is 85% black owned but has no black female shareholders will score less than a measured entity which is 25% black owned but has 10% black female shareholders.

- A measured entity which is 50% black owned with no black female shareholders will score marginally more (4 points) than a company which has 10% black shareholders all of whom are female (3.6 points). However, the entity which is 10% black owned is at risk of not complying with the 'ownership' Priority Element (it has not achieved the target) and having its empowerment level discounted as a result.[26]

- A measured entity with 10% black male shareholders (1.6 points) will score less than a measured entity with 10% black female shareholders (3.6 points).

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[24] Annexure 100 (E), paragraph 1.
[25] The example uses 25% as the target which makes the calculation simpler to understand. Verification agencies appear to interpret 25% plus 1 vote to mean 25.1%.
[26] See Table 5 on Priority Elements read with paragraph 4.4 which explains "Net Value".

- In given circumstances enterprises may have no choice but to forego potential partnerships with black males because the impact of empowerment scores on their business will compel them to find black female shareholders.

- In given circumstances black females will be able to attach a higher premium to their participation in business.

Referring to Table 4, there are three categories of indicators which make up the 25 points available under the ownership scorecard being voting rights (6 points), economic interest (11 points) and realisation points (8 points).

The same formulae and principles applied above to voting rights apply to the 11 points available for the “economic interest” component of the ownership scorecard. It will be seen that there are an additional 3 points available if economic ownership is held by other categories of black people and another 2 points are allocated to “New Entrants”. It is not necessary for present purposes to explore these possibilities. They are though potentially important and should be considered when implementing an empowerment transaction.

“Economic Interest” is essentially a right to receive dividends.[27] A purpose of this component of the ownership scorecard is to ensure that empowerment transactions do not result in black shareholders being perpetually denied a share of company profits.

It is accordingly not enough to transfer ownership and control to black shareholders and either (a) attach to such transfers loan accounts which take considerable time to be repaid or (b) structure company operations in a way which results in dividends not flowing to shareholders by, for example, paying management salaries above market rate.[28]

The Codes deal with point (a) above by *prescribing a time frame* within which debts attached to the acquisition of shares by black shareholders must be settled to qualify for empowerment points. This is part of the “**Net Value**” indicator which can be seen in Table 4 and Table 5.

[27] Schedule 1 to the Codes.
[28] The market rate of a salary is open to interpretation. This is an example of an area of dispute which should be avoided to the extent possible.

4.4 REALISATION POINTS REPRESENTED AS NET VALUE

There are 8 points available for the Net Value component under the ownership element of the scorecard. Net Value is a Priority Element and if 40% of the points available (being 3.2 points) are not obtained, the Measured Entity will be penalised a whole BBBEE level.

The Net Value score is the lower of two formulae provided in Statement 100 being.[29]

- **Formula A** (Net Value)

  Step 1 - Calculate the debt free portion of shares held by black people as a percentage of the value of the Measured Entity (the "**Deemed Value**").

  Step 2 - Multiply 25% by the applicable "**TBGF**" (see Table 7 below).

  Step 3 - Take the number 1 and divide it by the figure obtained in step 2.

  Step 4 - Deemed Value (step 1) multiplied by the figure obtained in step 3.

  Step 5 - Figure in Step 4 multiplied by 8.

- **Formula B** – which is the black **Economic Interest** as a percentage (discussed above) divided by the ownership target of 25% multiplied by 8.

Step 2 of Formula A involves the multiplication of the ownership target of 25% by a time based debt free target expressed as a percentage (the **TBGF**). The TBGF is represented in Table 7 below.

TABLE 7: TIME BASED GRADUATION FACTOR [TBGF]

END OF YEAR	TBGF	MINIMUM PERCENTAGE OF SHARES TO BE OWNED DEBT FREE BY BLACK SHAREHOLDERS
One	10%	1%
Two	20%	2%
Three	40%	4%
Five	60%	6%
Seven	80%	8%
Nine	100%	10%

The TBGF is critical to the calculation of the Net Value in Formula A. The effect of the way Net Value is calculated is to require shares held by black shareholders to be debt free (in other words paid for) within a prescribed period for points under the Net Value component to be claimable.

The third column in Table 7 shows the minimum target to be achieved in order to satisfy the Priority Element. The Codes now require all private companies in South Africa with a turnover above R50 million to be 10% owned by black people, failing which their respective empowerment levels are penalised.

[29] Annexure 100 (E) of Statement 100. The formula has been broken down into what are hopefully comprehensible steps.

Example

A black shareholder acquires shares valued at R1 million in a company valued at R5 million. A 10% deposit of R100 000 is paid with the balance of R900 000 recorded as a loan.

End of Year One – assuming values remain unchanged (see above for the steps)

Step 1 - the debt free portion of the black shareholder's shares is R100 000 which is divided by the value of the Measured Entity (R5 million) to give a figure of 2% (the Deemed Value expressed as a percentage)

Step 2 - 25% (ownership target) multiplied by 10% (the TBGF for year 1) = 0.025%

Step 3 - 1 divided by 0.025% (the figure in step 2) = 40

Step 4 - 2% (Deemed Value in step 1) multiplied by 40 (step 3 figure) = 80%

Step 5 - 80% (step 4 figure) multiplied by 8 (points available) = 6.4

With a score of 6.4 for year 1, the company has met the Priority Element.

End of year 2

If during year two the company pays the black shareholder R20 000 in after tax dividends which are used to pay off the balance due on the shareholder's shares:

Step 1 - the debt free portion of the black shareholder's shares is R120 000 which is divided by the value of the Measured Entity (R5 million) to give a figure of 2.4% (the Deemed Value expressed as a percentage)

Step 2 – 25% (ownership target) multiplied by 20% (the TBGF for year 2) = 0.05%

Step 3 – 1 divided by 0.05% (the figure in step 2) = 20

Step 4 – 2.4% (Deemed Value in step 1) multiplied by 20 (step 3 figure) = 48%

Step 5 – 48% (step 4 figure) multiplied by 8 (points available) = 3.8

With a score of 3.8 for year 2, the company has met the Priority Element.

End of year 3

If during year three the company pays the black shareholder R50 000 in after tax dividends which are used to pay off the balance due on the shareholder's shares:

Step 1 - the debt free portion of the black shareholder's shares is R170 000 which is divided by the value of the Measured Entity (R5 million) to give a figure of 3.4% (the Deemed Value expressed as a percentage)

Step 2 - 25% (ownership target) multiplied by 40% (the TBGF for year 2) = 0.1%

Step 3 - 1 divided by 0.1% (the figure in step 2) = 10

Step 4 - 3.4% (Deemed Value in step 1) multiplied by 10 (step 3 figure) = 34%

Step 5 - 34% (step 4 figure) multiplied by 8 (points available) = 2.7

With a score of 2.7 the company will have failed to satisfy the Net Value Priority Element which requires at least 3.2 points out of 8 to be achieved. The Company will be penalised a whole BBBEE level regardless of other empowerment achievements. With the TBGF changing to 60% in year four, a discount of an empowerment level could have serious implications.[30]

The following is evident from the principles which apply to Net Value under the ownership scorecard:

- In principle, if a black shareholder's shares are largely paid off but the black shareholder is not receiving dividends when dividends are available, it is likely the Net Value will be calculated with reference to the right to dividends.

- In principle, if a black shareholder is receiving dividends but the purchase price for his or her shares remain unpaid, the points for Net Value will likely be calculated with reference to the outstanding debt attached to the shares.

- To achieve the targets set, companies must ensure that shares held by black shareholders (a) result in the right to dividends and (b) are paid off within a prescribed time frame.

- The criteria set are harder to achieve for businesses which are already operating at the margin.

- The criteria set are harder to achieve for businesses which require a long-term investment. This is because such companies don't have cash available which can be distributed as dividends and used to settle debt attached to an empowerment shareholder's shares (assuming the shares were transferred along with a loan account).

It is not necessary to transfer 25% plus 1 vote to satisfy the ownership Priority Element. What is necessary is for a prescribed percentage of shares to be owned by black shareholders which are debt free with the end target being 10% after nine years.

The prescribed percentage depends on the year in question with reference to the TBGF. In the above example during year 1 a black shareholder held 2% of the shares in the company debt free (R100 000 / R5million = 2%) and this was enough to satisfy the Priority Element. In year three the black shareholder held 3.4% of the shares in the company debt free (R170 000/ R5 million =3.4%) but this was not enough to satisfy the Priority Element.

[30] The above examples are based on a face value interpretation of the Codes. It is possible directives could be issued which would impact the calculations. If the company is penalised, then both the white and black shareholders are affected. As a result of the company having a lower empowerment score, it will become more difficult to secure work and pay off the black shareholder's shares while at the same time the TBGF becomes more onerous. It is accordingly very important to stay ahead of the curve.

4.5 OWNERSHIP TARGETS AND REASONS FOR EMPOWERMENT TRANSACTIONS

The impact of ownership targets on empowerment ratings has been explained.

Table 8 below highlights some of the reasons an empowerment transaction might take place because of these ownership targets, taking into account related empowerment legislation, regulations and government policies. The first column identifies the reason, the remaining columns identify whether the reason would apply to a large enterprise, a QSE and/or an EME.

TABLE 8: REASONS FOR EMPOWERMENT TRANSACTIONS[31]

	REASON	LARGE ENTERPRISE	QSE	EME
1.	Change ownership to at least 25% black (plus 1 vote) to score maximum points under the ownership element (see Part 4.3 and Table 6).	YES	YES	NO
2.	Change ownership to keep up with minimum prescribed levels of debt free shares owned by black shareholders to achieve the ownership Priority Element and avoid being penalised (see Part 4.2 and Table 6). The end target is 10%.	YES	YES	NO
3.	Change the gender composition of ownership to score additional empowerment points (see Table 4, 2.1.2 and 2.2.2).	YES	NO	NO
4.	Set up and transfer shares to employee ownership schemes to score additional empowerment points (see Table 4, 2.2.3).[32]	NO	NO[33]	YES
5.	Change ownership to at least 51% black to be deemed a level 2 or 100% black to be deemed a level 1 (see Table 3).	NO	YES	YES
6.	To achieve a pre-qualifying empowerment score necessary to be considered for a tender (see Part 6 on the PPPFA).	YES	YES	YES
7.	To achieve an empowerment score to earn extra points for a tender (where no minimum empowerment level is necessary but where an improved empowerment level helps the prospects of being awarded work (see Part 6 on the PPPFA).	YES	YES	YES
8.	To change the gender makeup of ownership to be considered for a tender (see Part 6 on the PPPFA) – a tender can be allocated for specific categories of persons.	YES [34]	YES	YES
9.	To change the ownership composition in terms of race, gender, age and other criteria to qualify as a subcontractor for up to 30% of state work awarded to other private tenderers (see Part 6 on the PPPFA).	NO	NO	YES
10.	To achieve an empowerment score to obtain a license (see Table 12 for examples).	YES	YES	YES
11.	To achieve an empowerment score to qualify for state backed programmes, e.g. finance.[35]	YES	YES	YES

The above list is not exhaustive, and some reasons will naturally overlap.

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[31] Reference here is to transactions that are motivated primarily by the BBBEE Act.
[32] Employee ownership schemes or transactions involving the other categories identified in Table 4, 2.2.3 are not covered here.
[33] The scorecard on ownership for QSE's does not mention employee share schemes but it does mention "Black Designated Groups". An empowerment transaction could include the transfer of shares to an entity set up for the benefit of Black Designated Groups.
[34] It is unlikely these types of tenders will be allocated for large enterprises but it is not impossible.
[35] This is not covered here but is worth mentioning.

4.6 CONCLUSION ON OWNERSHIP TARGETS

The ownership element compels businesses of all sizes to restructure if they are to obtain a reasonable empowerment score. The empowerment score following a restructuring will be largely influenced by the gender of new shareholders.

If a business with a poor BBBEE rating does not transfer ownership of a prescribed shareholding to a black person within a prescribed period, the ownership Priority Element under the Codes will not be achieved, and its empowerment rating will be penalised. A percentage of the shares transferred must be debt free and result in the right to dividends (and voting rights) with reference to a prescribed period in order for BBBEE points to be maintained. If not adhered to, this could result in a situation where costs have been incurred and risks taken in partnering with new shareholders without an ongoing commensurate benefit to a company's empowerment rating.

Empowerment transactions must only be entered into with a careful plan to satisfy these criteria. In addition, it is important that consideration be given to the risk of fronting.

Fronting is considered in detail further below. First though, a summary of how the Enterprise and Supplier Development element compels empowerment transactions to be undertaken is provided.

5. HOW DEVELOPMENT TARGETS INFLUENCE EMPOWERMENT TRANSACTIONS

5.1 INTRODUCTION TO DEVELOPMENT TARGETS AND THE INFLUENCE ON QSEs AND EMEs

The Enterprise and Supplier Development ("**ESD**") element measures: "the extent to which entities buy goods and services from "**Empowering Suppliers**" with strong B-BBEE recognition levels".[36]

The ESD element is worth the most points in the Generic Scorecard as well as the QSE scorecard (see Table 3). 40 points (44 with bonus points) are available on the Generic Scorecard and 30 points (33 with bonus points) on the QSE scorecard. These points are broken down into sub elements which are (a) preferential procurement (b) supplier development and (c) enterprise development (see Table 5).

The ESD element is also a Priority Element which means entities with an annual revenue above R50 million ("**Large Enterprises**") are required to score at least 40% of the points available for *each* of the sub elements failing which their BBBEE levels will be discounted by one level. QSE's may elect to either achieve the targets for the ESD Priority Element or the targets for the skills development Priority Element (see table 5 above on "minimum compliance") failing which their BBBEE levels will also be discounted by one level.[37]

[36] Statement 000, paragraph 7.4.
[37] Statement 000, paragraph 3.3.2.2.

The calculation of the score for the ESD element is not examined in detail here as was done with the ownership element. The focus here is also not on how the QSE ESD scorecard differs from the Generic ESD scorecard.[38] The focus is rather on how the mechanics of the Generic ESD scorecard puts pressure on Measured Entities to spend money on services provided by certain categories of suppliers and how this influences the decisions of QSEs and EMEs to enter into empowerment transactions.

5.2 EMPOWERING SUPPLIERS AND THE ADVANTAGES OF BEING 51% BLACK OWNED

(** Note that The Department of Trade and Industry ("DTI") issued a notice in November 2016 in terms of which all measured entities are deemed as Empowering Suppliers until further notice.[39] In the interim, scores for this element are still influenced by the BBBEE Recognition Level of suppliers and pressure is accordingly placed top down for suppliers to obtain good empowerment credentials.)

Assuming that at some point further notice is provided by the DTI to the effect that measured entities are no longer deemed as Empowering Suppliers, what is set out below is important to understand.

The first point is that Measured Entities are not (according to the Codes and in the absence of the current 'deeming position' explained above) able to claim points for the ESD Element when they buy goods or services from any business which is not an "**Empowering Supplier**". In other words, to obtain points on the ESD element, the scorecard requires a Measured Entity to spend a prescribed amount of its procurement budget on **Empowering Suppliers**.

The definition of an **Empowering Supplier** includes requirements such as being a "good citizen South African entity" [sic].[40] There are, in addition, various criteria which must be met relating to the make-up of a labour force, job creation, the source of raw materials and skills transfer obligations.[41] These additional criteria are set out in Table 9 below.

[38] Statement 604 for QSEs and Statement 400 being the Generic Scorecard for Large Enterprises.
[39] Government Gazette 708 of 2016. Until further notice, it is enough to be measured by a verification agency.
[40] A "good citizen" is one which has paid its taxes, resulting in private persons having to verify the tax compliance of entities they trade with.
[41] See Schedule One to the Codes, definition of "Empowering Supplier".

TABLE 9: CRITERIA FOR EMPOWERING SUPPLIER STATUS

CRITERIA (same wording from Statement 400, 3.3 (a) to (e)).	**LARGE ENTERPRISE**	**QSE**	**EME**
At least 25% of cost of sales excluding labour cost and depreciation must be procured from local producers or local suppliers in SA, for service industry labour cost are included but capped to 15%.	Must satisfy at least three of the criteria.	Must satisfy at least one of the criteria. Money spent on a black owned QSE (51% black owned) in terms of a 3-year contract can be multiplied by a factor of 1.2 [42] A 51% black owned QSE qualifies as a "Beneficiary" and suppliers can count additional actions as a spend including: Loans Guarantees Discounts[43]	Automatically an Empowering Supplier. Money spent on a black owned EME (51% black owned) in terms of a 3-year contract can be multiplied by a factor of 1.2 [44] A 51% black owned QSE qualifies as a "Beneficiary" and suppliers can count additional actions as a spend including: Loans Guarantees Discounts[45]
Job creation - 50% of jobs created are for Black people provided that the number of Black employees since the immediate prior verified B-BBEE Measurement is maintained.			
At least 25% transformation of raw material/beneficiation which include local manufacturing, production and/or assembly, and/or packaging.			
Skills transfer - at least spend 12 days per annum of productivity deployed in assisting Black EMEs and QSEs beneficiaries.			
At least 85% of the labour costs should be paid to South African employees by service industry entities.			

The way money spent on different suppliers can be allocated to empowerment points is complicated. What can be ascertained from Table 9 includes the following:

- Some Large Enterprises might not be able to achieve three of the six available targets which must be achieved as a minimum to be classified as an Empowering Supplier. This might in turn impact their ability to source work from Measured Entities who need to contract with Empowering Suppliers to score points towards the ESD Priority Element.

- It will be easier for QSEs and EMEs to qualify as Empowering Suppliers. The former need to satisfy one of the six available criteria and the latter automatically qualify.

[42] Statement 400, paragraph 3.5.2.
[43] Statement 400, paragraph 3.7 read with paragraph 9.
[44] Statement 400, paragraph 3.5.2.
[45] Statement 400, paragraph 3.7 read with paragraph 9.

- Pressure will be placed on Measured Entities to use the services of smaller suppliers. In doing so these Measured Entities will have to weigh up the additional costs, if any, of using smaller suppliers against the need for points on the ESD Element.[46]

- Some Large Enterprises who operate at the margin of being classified as a QSE might elect to downsize their operations if the cost of not being eligible as an Empowering Supplier is too high.

In addition, it can be gleaned from Table 9 that some QSEs and EMEs which are less than 51% black owned will choose to restructure so that they are at least 51% black owned to benefit from two advantages being:

- Advantage One: Money spent on a QSE or EME which is 51% black owned (or more) can be multiplied by a factor (the "**Factoring Benefit**").

- Advantage Two: Suppliers can provide other types of assistance to QSEs and EMEs which are at least 51% black owned, which assistance can be counted as a spend towards ESD targets. Such assistance includes investments, loans, guarantees, credit facilities, certain costs otherwise not claimable, preferential terms and discounts.[47] (the "**Contribution Method Benefit**").[48]

TABLE 10: THE IMPACT OF RECOGNITION LEVEL ON THE ESD ELEMENT

AMOUNT SPENT	SUPPLIER RECOGNITION LEVEL	AMOUNT CLAIMABLE
R100 000	135%	R135 000
R100 000	125%	R125 000
R100 000	110%	R110 000
R100 000	100%	R100 000
R100 000	80%	R80 000
R100 000	60%	R60 000
R100 000	50%	R50 000
R100 000	10%	R10 000
R100 000	0%	R0

[46] Due to less economies of scale, smaller suppliers are often more expensive.
[47] Statement 400, paragraph 3.7 read with paragraph 9.
[48] The Factoring Benefit and the Contribution Method Benefit are not defined terms in the BBBEE Act or the Codes. They have been made up.

The impact of the Recognition Level of Suppliers on amounts claimable by Measured Entities which pay for their services can be seen in Table 10.

It is unclear when the position on who qualifies as an Empowering Supplier will change. In the interim many companies will anticipate that at some point the definition of **Empowering Suppliers**, as provided for in the Codes, will come into effect.

5.3 HOW RING-FENCED ESD POINTS BENEFIT BLACK OWNED BUSINESSES

The ESD scorecard allocates ring fenced points when money is spent on various *categories* of suppliers. Table 11 provides examples.

TABLE 11: SPECIFIC MAKE UP OF SUPPLIER FOR ESD POINTS

CRITERIA	POINTS	COMPLIANCE TARGET
Preferential Procurement (Priority Sub-Element)		
2.1.4 B-BBEE Procurement Spend from Empowering Suppliers that are at least 51% black owned based on the applicable B-BBEE Procurement Recognition Levels as a percentage of Total Measured Procurement Spend.	9	40%
2.1.5 B-BBEE Procurement Spend from Empowering Suppliers that are at least 30% black women owned based on the applicable B-BBEE Procurement Recognition Levels as a percentage of Total Measured Procurement Spend.	4	12%
2.1.5 B-BBEE Procurement Spend from Designated Group Suppliers that are at least 51% black owned.	2	2%

There will conceivably be instances when, to score enough points towards the ESD Priority Element, a Measured Entity will require its suppliers to be 51% black owned and/or 30% owned by black women. As a result, some businesses might be *pressured to* or alternatively will *decide to restructure* (in the absence of pressure) to be 51% black owned and/or 30% black women owned with a view to securing this work.

The last item in Table 11 refers to "Designated Group Suppliers" and 2 points being available. These are described as "Bonus Points" in Statement 400. If the 2 bonus points are added to the other points available under "Preferential Procurement" the total is 27 (not all the available points are identified in Table 11). However, the maximum points available under this sub element is 25.

As identified in Table 5, the target for the ESD Priority Element is 40% for each Indicator or sub element. If this is not achieved, the Measured Entity's empowerment level will be discounted. These bonus points are accordingly potentially important.[49]

[49] The details around Designated Group Suppliers is not covered here.

5.4 CONCLUSION ON THE ESD TARGETS

Because of the importance of the ESD Priority Element, it is not uncommon for suppliers to receive letters from their customers advising them to improve their empowerment level failing which continued business is at risk.

From what has been highlighted on the ESD Priority Element, a supplier must consider matters from a few angles, including whether it:

1. has the Recognition Level its customers need it to have;
2. has the optimal ownership structure its customers can benefit from; and
3. whether it will be able to maintain its Empowering Supplier Status once the DTI's position referred to above changes.

Table 12 highlights some of the reasons an empowerment transaction might take place as a result of the ESD Priority Element and the pressure it creates 'down the business chain' on suppliers. The first column identifies the reason for a given empowerment transaction, the other columns identify whether the reason would apply to a Large Enterprise, a QSE and/or an EME.

TABLE 12: ESD & REASONS FOR EMPOWERMENT TRANSACTIONS[50]

	REASON	LARGE ENTERPRISE	QSE	EME
1.	Restructure to at least 51% black ownership to obtain the Factoring Benefit and the Contribution Method Benefit (explained above).	NO	YES	YES
2.	Restructure to at least 51% black ownership to allow customers to claim up to 9 points under 2.1.4, Statement 400. See Table 11 above.	YES	YES	YES
3.	Restructure to at least 30% black women ownership to allow customers to claim up to 4 points under 2.1.5, Statement 400. See Table 11 above.	YES	YES	YES

The restructurings identified in Table 12 will be primarily motivated by protecting or securing business with private enterprise as opposed to being motivated by tenders or the need to obtain a license. There may of course be other overlapping reasons.

The impact of Empowerment Law and public tenders will now be considered.

[50] Transactions would take place without the BBBEE Act. Reference here is to transactions that are motivated primarily by the BBBEE Act, the ESD Priority Element and related empowerment legislation.

6. PUBLIC TENDERS AND EMPOWERMENT: THE PPPFA

6.1 TENDERS AND THE CONSTITUTION

The consolidated government expenditure of the South African government for the 2018/2019 budget is approximately R1 600 000 000,00 (One comma Six Trillion Rand).[51] A significant portion of this budget is allocated for work to be performed by private enterprise and which is sourced through a regulated procurement (tender) process.

Chapter 13 of the Constitution regulates government finances.[52] Section 217 of the Constitution is the section under Chapter 13 which regulates procurement. Section 217 is made up of three subsections.

- Section 217 (1) provides that when an organ of state contracts for goods or services it must do so in accordance with a system which is fair, equitable, transparent, competitive and cost effective.
- Section 217 (2) provides that subsection 1 *does not prevent* organs of state from implementing a procurement policy providing for (a) *categories of preference* in the allocation of contracts; and (b) the *advancement of categories of persons* disadvantaged by unfair discrimination.
- Section 217 (3) provides that National legislation must prescribe a framework within which the policy referred to in section 217 (2) must be implemented.

6.2 TENDERS AND THE PPPFA

The Preferential Procurement Policy Framework Act 5 of 2000 ("**PPPFA**") is the legislation which gives effect to section 217 (3) of the Constitution. The PPPFA is made up of only six sections.[53] It is possibly one of the shortest pieces of legislation in South Africa. However, its impacts are far reaching.

Section 2 of the PPPFA provides for organs of state to implement their own procurement policies within a framework provided.[54] Within this framework is the option to score tenders using a system which allocates extra points based on empowerment ratings.[55]

There is a difference between an empowerment score being the basis for the allocation of extra points in a tender process and an empowerment score being used as pre-qualifying criteria. Prior to 2017 empowerment scores were not used as pre-qualifying criteria for state tenders. How this changed is explained below.

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[51] National Treasury, Budget Review, 21 February 2018, page 5.
[52] Constitution of the Republic of South Africa, 1996, Chapter 13.
[53] The BBBEE Act is also very short, it being made up of only 15 sections. Contrast this with the Companies Act 71 of 2008 which has 225 sections.
[54] The definition of an 'organ of state' is not always clear. See section 1 (iii) (f) of the PPPFA. See also Government Notice 571 of 2017 clarifying which institutions the PPPFA applies to.
[55] PPPFA, section 2(1)(b).

Section 5 of the PPPFA provides that the Minister of Finance may make regulations regarding any matter that may be necessary or expedient to prescribe in order to achieve the objects of the PPPFA.[56]

In January 2017 the Minister of Finance published regulations as contemplated in section 5 of the PPPFA (the "**Regulations**"). The Regulations provide formulae for how points may be allocated to empowerment scores in any given tender. While these formulae are important, the Regulations go further than simply allowing for extra points to be allocated based on an empowerment score.

The Regulations provide that an organ of state may apply *pre-qualifying* criteria to advance certain designated groups of persons. Such designated groups include (a) tenderers with minimum BBBEE ratings, (b) EMEs or QSEs and/or (c) tenderers who subcontract a prescribed 30% of a project awarded to EMEs owned at least 51% by various categories of persons. These 'categories of persons' include black people, black youth, black women, black people with disabilities and black people living in the rural areas.[57]

This is an example of how law in the Constitution can be refined through legislation and then adjusted further through regulations, with it being difficult to connect the end result with what was initially contemplated. The sequence of events is summarised in Table 13.

TABLE 13: THE DEVELOPMENT OF PROCUREMENT CRITERIA

DATE	LAW	PROVIDES FOR
1996	Constitution	Tenders to be fair, equitable, transparent, competitive and cost effective but State may create a system for preferring categories of persons.
2000	PPPFA	Organs of state to implement their own procurement policies within a framework provided. Within this framework is the option to score tenders using a system which allocates extra points based on empowerment ratings.
2017	Regulations	Pre-qualifying criteria apply including empowerment levels and/ or make up of tenderer based on race, gender, age, military background and disability status.

[56] The stated object of the PPPFA is to give effect to section 217 (3) of the Constitution and to provide for matters connected therewith.
[57] Preferential Procurement Regulations 2017, regulation 4.

Under the Regulations, a tender which fails to meet any prequalifying criteria stipulated is deemed unacceptable. As a result, in some cases, tenders will no longer be evaluated if they are submitted by entities which are not owned by a designated group of people, as determined by the relevant organ of state which requires work to be done. A "designated group" can be based on race, gender, age, military background or disability status.

6.3 CONCLUSION ON THE PPPFA

The PPPFA read with the Regulations makes it critical for businesses who want to secure government contracts to restructure their ownership make up. If they fail to do so it is likely many will not even be considered for certain government tenders.

7. LICENSES AND EMPOWERMENT

As identified in Table 8 and Table 12 there are many reasons why a given empowerment transaction might be necessary. These transactions can be on two levels as explained in the example below. The first level involves the restructuring of a company which requires a license or is hoping to be awarded a tender. The second level involves the restructuring of suppliers to this company.

In the example provided a company requires one of the licenses or permits identified in Table 14.

TABLE 14: EXAMPLES OF PERMITS INFLUENCED BY EMPOWERMENT

INDUSTRY	PERMIT	LEGISLATION AND COMMENT
Agriculture, Industry	Water Use License	National Water Act 36 of 1998 (NWA). In terms of the National Water Resource Strategy, gazetted under section 5 of the NWA, "the water allocation process must contribute to black empowerment" and certain catchment water and authorizations may be set aside for black people and/or black women.[58]
Petroleum	Construction or operation of pipelines, loading and storing facilities.	Petroleum Pipelines Act 60 of 2003 – section 20 provides that the National Energy Regulator may impose license conditions to promote historically disadvantaged South Africans and licensees may be required to provide prescribed information detailing the involvement of historically disadvantaged persons in their operations.

[58] National Water Resource Strategy 2013, page 70, 73

INDUSTRY	PERMIT	LEGISLATION AND COMMENT
Mining	Prospecting rights and mining rights.	Broad Based Black Economic Empowerment Mining Charter for the South African Mining and Minerals Industry. Permit or license holders are required to comply with targets.
Forestry	Various licenses or leases	National Forests Act 84 of 1998 – the preamble records that the economic benefits of forests were unfairly distributed. Regulations, 1998 regulate licenses. The Amended Forest Sector Code, 2017 aims to consider BBBEE in the allocation of leases.
Services to Ports	Waste and other licenses	National Ports Act 12 2005 National Ports Regulations. Regulation 3 covers BBBEE targets and Regulation 3 (1) provides that at least 25% of all licenses issued must be issued to entities with prescribed minimum empowerment levels.

Empowerment criteria for permits is not always expressly set out in legislation or regulations. It can be part of a departmental policy and this makes it difficult to know what criteria are or when they will change.

A restructuring might not always be necessary but in this example, the company which requires the license (the "**Licensed Company**") must undergo a restructuring for it to *obtain* its license and it happens to need 25.1% black shareholders.

Assuming there are no current black shareholders, this would normally entail a transaction in which a black person/s aquire/s at least a 25.1% shareholding in the Licensed Company (purchased from a shareholder or issued by the company). Ideally, as identified in the analysis of the ownership element in Part 4, to secure maximum points this transaction would include a 10% shareholding for black women.

Note that for multinational companies there is an alternative process available involving the "Recognition of Equity Equivalents".[59] This involves a payment by the Multinational to a prescribed "Equity Equivalent Investment Programme" ("**EEIP**") as an alternative to transferring a portion of ownership.[60]

A supplier of services to the Licensed Company may in turn need to change the way it operates, alternatively restructure the ownership of its business in order to qualify as an Empowering Supplier (currently not necessary as explained) and/or to improve its Recognition Level (which is currently relevant) so that the Licensed Company can score enough points on the ESD Priority Element (see Part 5), which are necessary to *maintain* its BEE rating and its license.

[59] Codes, Statement 103.
[60] Codes, Statement 103.

The restructuring of the supplier could in a given situation be potentially more onerous because, as in this example, for the Licensed Company to obtain maximum necessary BBBEE points, it has determined that it must spend money on businesses which are 51% black owned and businesses which are 30% owned by black women (see Table 11). If critical service providers cannot achieve this, the Licensed Company's operations are at risk.

Ultimately, the Licensed Company must weigh up the following alternatives if a supplier does not have the requisite black/gender shareholding (or Recognition Level in other possible scenarios): the economic benefit of using the supplier considering the importance of its expertise, experience, efficiencies, reliability, quality and cost versus the risk of not scoring enough BEE points and thereby going out of business due to a critical permit being denied. The Licensed Company may have no choice but to threaten cutting its business from certain suppliers.

The suppliers will in turn need to carefully assess the importance of what they provide, and the revenue earned from the Licensed Company, against the costs and risks of changing how they operate and/or restructuring.

8. RATINGS AND THE COMMISSION

It should now be appreciated that empowerment ratings are increasingly important for obtaining government contracts, licenses and permits as well as doing work for any other business remotely reliant on government. This extends even to the ability to attract donations.[61]

Incentives for high empowerment scores combined with a great quantity of nuanced and difficult-to-interpret scoring criteria have created fertile ground for creative company structures and contractual arrangements, the legality of which can be open to interpretation.[62] These arrangements can be born out of an arguably forgivable natural survival instinct or an unscrupulous intention to profit by manipulating a highly regulated system. Either way, actions which breach the law are increasingly susceptible to severe inconvenience and punishment.

To address many challenges relating to the implementation of the empowerment campaign, the Commission was formed under the BBBEE Act and started operating in April 2016.[63] The Commission has a broad mandate which includes processing and investigating complaints and maintaining a registry of "major BBBEE transactions" valued over a prescribed threshold.[64]

[61] Charities have become increasingly affected as donors are compelled to donate to charities with good BEE scores to improve their own compliance status. The writer has recently advised public benefit organisations, which focus on AIDS and HIV charity work, who are struggling with BEE legislation and its impact on their operations.
[62] Including creative company founding documents, shareholder agreements and joint ventures.
[63] BBBEE Act 53 of 2003, section 13B. Inserted by section 8 of Act 46 of 2013.
[64] BBBEE Act 53 of 2003, section 13F. The threshold is currently R25 million but the circumstances when it applies are open to interpretation. See GG40898 of 9 June 2017.

In its first year of operation the Commission received approximately one hundred and eighty complaints relating to noncompliance with the BBBEE Act in some form or another. This represents close to four complaints a week.

In its latest annual performance plan, the Commission identifies fronting as the subject matter of over 80% of the complaints received. This suggests that there are close to three complaints a week made to the Commission relating to fronting.[65]

Parties involved in BEE transactions including shareholders, directors and financiers should be alive to the possibility that company structures they participate in could be the subject of intense scrutiny by the Commission following the compulsory filing of a major BBBEE transaction or the lodging of a complaint.

In particular, it must be appreciated that fronting is a serious crime under the BBBEE Act that comes with the potential of up to ten years in prison and/or a fine of up to 10% of annual turnover.[66] It is accordingly an important concept to understand, particularly when structuring one's affairs in the context of an empowerment transaction.

9. THE CRIME OF FRONTING

9.1 THE DEFINITION OF FRONTING

Fronting in some parts of the world refers to the act of intentionally identifying the wrong person as the main driver under a vehicle insurance policy.[67] In South Africa, it has different connotations.

Following an insertion into the BBBEE Act effective as from October 2014, "fronting practice" is defined as:

- a transaction, arrangement or other act or conduct that directly or indirectly undermines or frustrates the achievement of the objectives of the BBBEE Act; or
- the implementation of any of the provisions of the BBBEE Act, including but not limited to practices in connection with a B-BBEE initiative which result in _one_ *of* a list of outcomes, identified in Table 15 below.[68]

[65] Annual Performance Plan of the Commission 2017 to 2020 – https://bbbeecommission.co.za/
[66] Section 13 (O)(3) of the BBBEE Act.
[67] This is what "fronting" is in the UK. The purpose of the crime, which is considered fraud, is to lower premiums.
[68] BBBEE Act, section 1, definition of "fronting practice" inserted by Act 46 of 2013 with effect on 24 October 2014.

TABLE 15: FRONTING PRACTICES

	MAY BE CONSIDERED FRONTING PRACTICE IF:	APPEARS TO RELATE TO:	POSSIBLE EXAMPLES?
(a)	black persons who are appointed to an enterprise are discouraged or inhibited from substantially participating in the core activities of that enterprise	The extent to which black shareholders and/or directors can participate in decisions.	Restrictions placed on new black directors in a memorandum of incorporation or shareholders agreement which cannot be justified. New directors might not be given proper notice of meetings and/or notice of minority shareholder rights.[69]
(b)	the economic benefits received because of the broad-based black economic empowerment status of an enterprise do not flow to black people in the ratio specified in the relevant legal documentation	The extent to which perceived benefits which flow to black people, based on the face value of documentation, correlates to the actual monetary benefit received.	A joint venture is entered into with a company with a strong empowerment status necessary to secure work. The black JV partners income does not correlate to its stated interest in the JV.
(c)	the conclusion of a legal relationship with a black person for that enterprise to achieve a certain level of BBBEE compliance without granting that black person the economic benefits that would reasonably be expected to be associated with the status or position held by that black person	The extent to which perceived benefits which flow to black people, based on the face value of documentation, correlates to the actual monetary benefit received.	Paying a senior black manager a lower salary than what a senior manager in the circumstance would be expected to earn.
(d)	the conclusion of an agreement with another enterprise to achieve or enhance BBBEE status in circumstances in which:	Ensuring that agreements with black enterprises entered for the purpose of improving an empowerment status reflect the expected commercial terms which would have existed in the absence of empowerment legislation. *See Prasa v Swafambo below	Any conditions which cannot be justified with reference to usual commercial practice under the circumstances.
(i)	there are significant limitations, whether implicit or explicit, on the identity of suppliers, service providers, clients or customers;		If any unusual secrecy provisions are included or efforts made to isolate the enterprise.
(ii)	the maintenance of business operations is reasonably considered to be improbable, having regard to the resources available; or		An agreement which serves no substantive purpose other than empowerment.
(iii)	the terms and conditions were not negotiated at arm's length and on a fair and reasonable basis.		Tokenism, unusual contract terms on duration, ordering procedures, risks, cancellation rights and penalties.

[69] This could be in breach of the BBBEE Act as well as a breach of minority protection rights provided in the Companies Act 71 of 2008.

The highlighted words in Table 15 emphasise that there are subjective terms relating to the crime of fronting. All the following words or phrases are relative.

- “discouraged”
- “substantially participating”
- “core activities”
- “reasonably be expected”
- “significant limitations”
- “reasonably considered”
- “fair and reasonable basis”

Uncertainty arises because whether fronting is committed is a question of degree under the circumstances of a given case.

For example, the word “discouraged” means to “dissuade or deprive of confidence” and a “core activity” means a “business function which is critical”.[70] Does this mean that fronting is committed if a “black person appointed to an enterprise” is deprived of the confidence to “participate in a critical function of the enterprise”? How is this tested?

These questions are of considerable importance to all participants involved in empowerment transactions.

9.2 PRASA v SWAFAMBO

Enter Passenger Rail Agency of South Africa (**PRASA**) v Swafambo Rail Agency (Pty) Ltd (**Swafambo**) 2017 (6) SA 223 (South Gauteng High Court).

In 2013 Swafambo, a black owned company, was awarded a contract to supply locomotives to PRASA.[71] The contract involved Billions of Rands. After a portion of the contract had been implemented PRASA applied to court to cancel on several grounds including that Swafambo had engaged in fronting.

It was alleged by PRASA that the contractual arrangement between Swafambo and the actual supplier of the locomotives, a German company (the “**Supplier**”) undermined the objectives of the BBBEA and therefore constituted fronting.

The High Court found in favour of PRASA and set aside the award of the contract. In its award the court held that the contractual arrangement between Swafambo and the Supplier amounted to fronting. Importantly, the High Court made it clear that the test for fronting does not focus only on whether an empowerment participant (in this case Swafambo) is satisfied with an arrangement, but it is rather directed towards whether the broader objectives of the BBBEE Act are frustrated.[72]

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[70] See www.businessdictionary.com
[71] PRASA is an ‘organ of state’ as contemplated under the PPPFA because it is identified as a National Government Business Enterprise in Schedule 3, Part B of the Public Finance Management Act 1 of 1999.
[72] PRASA v Swafambo, p239, paragraph 98.

The following important considerations were cited as relevant to the conclusion that in this case the broader objectives of the BBBEE Act were frustrated:

- There were inherent limitations on the agreement between Swafambo and the Supplier as contemplated in paragraph (d) (i) of the definition of fronting – see Table 10 above.
- The supplier was an international company which had avoided other mechanisms for it to invest in South Africa to earn empowerment points necessary to do business with organs of state.[73]
- No skills were transferred to the empowerment partner.
- Swafambo was obliged to destroy confidential information of the Supplier once the contract was completed.

Some of the factors cited as reasons why the High Court concluded fronting was committed may be of concern to people presently involved in comparable relationships as well as those contemplating the conclusion of empowerment transactions

Careful consideration must always be given to the obligations of all parties involved in relation to the objectives of the BBBEE Act. Who is responsible for training? What is the consequence of the relationship ending? How should contractual arrangements be structured? What record keeping processes are in place?

In the context of an empowerment transaction involving the transfer of business ownership, it is important for the content of memoranda of incorporation and shareholders' agreements to be carefully considered. Terms which may require special attention include those relating to quorums, voting procedures, resolutions, lock-in periods, call options, death provisions, and any restrictive conditions in general which apply to an empowerment shareholder's shares which do not apply to other shares.[74]

10. LEGAL CERTAINTY AND THE DECISION TO RESTRUCTURE

Proponents of the BBBEE Act argue that it is necessary to correct wrongs of the past and to secure an equitable and sustainable future. Critics of the BBBEE Act contend that the state is irrationally dictating, in an increasingly detailed manner, the composition of thousands of businesses without understanding the circumstances of each specific one.[75]

They contend it results in some enterprises being excluded from competing in a market (including enterprises which have black shareholders and/or employ black people) while forcing others to use suppliers which they would otherwise not and thereby unavoidably causing inefficiencies and risks which are impossible to quantify. They argue that such inefficiencies negatively impact the price of goods, company profits and tax collection necessary for the state to deliver services.

[73] See Statement 103.
[74] This opens questions around creating classes of shares and compatibility with the BBBEE Act.
[75] This is connected to the 'knowledge problem' in economics, alluded to by the Nobel Prize winner Friedrich Von Hayek. Essentially, it is the observation that the data required for rational economic planning are distributed among individual actors, and thus unavoidably exist outside the knowledge of a central authority.

Another criticism of the BBBEE Act is that it forces owners of business in many instances to effectively give away a percentage of their property in the form of their shares. There is presently much heated debate around government's plan to introduce a policy of expropriating ownership of land (primarily farm land) without compensation. What is missed, the critics contend, is that empowerment legislation has been implementing a policy which results in the loss of ownership of business for over 15 years. Supporters argue that this is the intention that it will result in benefits for the wider population and it must be viewed with this objective in mind.

The different points of view aside, most will agree that certainty and consistency is important. The challenge appears to be understanding what the end rules will be, with neither business nor the state able to give an answer.

In March 2018 further proposed amendments to the Codes were published creating additional categories of persons eligible for different treatment to others.[76] Many amendments are proposed including the creation of a Youth Employment Service Initiative, intended to benefit people between the ages of 18 to 35 and their employers. People over 35 years of age will not have preference. Detailed formulae are included.

In June 2018 proposed changes to the definitions which apply to the Codes were gazetted along with changes to Statement 400 and how Enterprise and Supplier Development is measured.[77] In addition to changing existing definitions and adding new definitions, the notices introduce different targets, for example on spending to be allocated to 51% black owned businesses. These changes have potentially serious implications.

Faced with the BBBEE Act, the Codes and a large quantity of other legislation, policies, rules and ever-changing targets, exceptions, waivers, flow through principles (an important principle not covered here) priorities and penalties, businesses are confronted with the question whether they can be confident there exists legal certainty, a central pillar to the principle of the rule of law. Such questions around unpredictable property rights make President Ramaphosa's task of encouraging investment a challenging one.[78]

This introduces another element to consider before implementing empowerment transactions. After new structures and systems are put in place, what will happen if the rules change?[79]

[76] Government Gazette Number 41546 23 March 2018.
[77] Government Gazette Number 41709 15 June 2018.
[78] The BBBEE Act has been cited as a reason for failed trade negotiations between South Africa and the USA. See SCHNEIDERMAN D, "Promoting equality, black economic empowerment and the future of investment rules", SA Journal on Human Rights, 2009, Volume 25, Part 2, p248.
[79] At the time of writing mainstream media is reporting that the Democratic Alliance believes the current model is unsustainable. For an example on how the Codes are drafted in a manner which contemplates change based on circumstances, consider the wording of paragraph 3.10.7 in Statement 102 in relation to how the ownership of shares by private equity funds is treated.

11. EMPOWERMENT AND PUBLIC BENEFIT ORGANISATIONS

Empowerment Law has broad implications for profit and nonprofit entities.

For example, international donations from all over the world including other governments are given to assist those with HIV and/or AIDS in South Africa. A significant portion of these donations, which amount to hundreds of millions of dollars, are allocated through a vetting process managed by an organisation called the South African National Aids Council (**SANAC**).

SANAC is tasked with allocating this funding to appropriately qualified and experienced nonprofit organisations called "principal recipients" who manage the use of these donations.

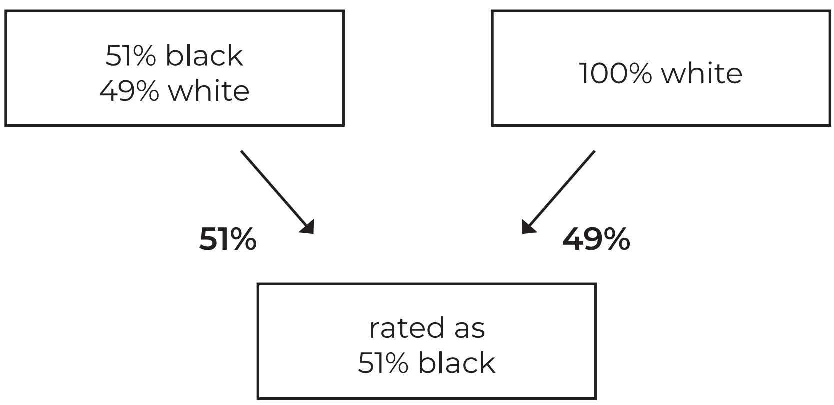
There are now circumstances where only principal recipients with an empowerment level of 3 will be considered eligible to be a recipient of such funding, while another classification of recipients called "sub-recipients" must have a level 2.[80]

It is accordingly important for all organisations to review their empowerment levels. Statement 004 applies a scorecard for specialised enterprises which includes non-profit companies and public benefit organisations.[81]

12. IMPORTANT TOPICS NOT COVERED

There are many important topics not covered. Some which must be mentioned are:

- The **Modified Flow Through Principle** – allows a company which is 51% black owned to be treated as if it were 100% black owned when assessing the ownership element of a company which it is a shareholder of. In practice this allows a company which ultimately has 26% black ownership to be treated as if it has 51% black ownership. Note that there are rules which apply.[82]



[80] South Africa Global Fund Country Co-ordination Mechanism, Principal Recipients Selection Manual, "Advancing Transformation" page 7, paragraph 4.3.
[81] Codes, Statement 004.
[82] Statement 100, paragraph 3.4.

- **Sector Codes** – these are codes which apply to specific sectors in replace of the Generic Codes. Sector codes apply to several industries including construction, property, forestry, agriculture, mining, marketing and advertising, information and communication technology and tourism.[83]

- **Implications following sale of shares by a black shareholder** – special provisions apply in Statement 000. Continued empowerment recognition is dependent on criteria and qualifications.[84]

- **Recognition of the sale of assets** – the sale of assets to black people can be recognised for scoring ownership points. Detailed conditions and formula apply.[85]

- **Private Equity Funds** – ownership by a private equity fund may be treated as ownership by black people when certain criteria are met.[86]

- **Ownership Schemes and employee ownership programmes** – can be counted towards a maximum of 40% of the total points on the ownership scorecard of a Measured Entity if they meet certain criteria and up to 100% of the total points on the ownership scorecard if they meet additional criteria.[87]

- **Trusts** - can be counted towards a maximum of 40% of the total points on the ownership scorecard of a Measured Entity if the trust meets certain criteria and up to 100% of the total points on the ownership scorecard if the trust meets additional criteria.[88]

13. CONCLUSION

The BBBEE Act and related Empowerment Laws and Regulations are part of doing business in South Africa. Careful consideration should be given to empowerment ratings and how empowerment transactions are structured.

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Empowerment Law services include:

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- Setting up BEE structures
- Establishment of broad based ownership schemes
- Assisting with the resolution of shareholder disputes
- Advice on obligations to the BBBEE Commission
- Advice on Fronting
- Advice on Companies Act 71 of 2008.

[83] Codes, Statement 003: Amended Guidelines for Developing and Gazetting Sector Codes.
[84] Statement 100, paragraph 3.8. This introduces many potential further complications including around who purchases a black shareholder's shares. If a black shareholder can only sell shares to a black person then are these shares not of a different class? How does this impact their value?
[85] Codes, Statement 102.
[86] Codes, Statement 102, paragraph 3.10.
[87] Codes, Statement 100, paragraph 3.9.
[88] Codes, Statement 100, paragraph 3.12.