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BLACK ECONOMIC EMPOWERMENT ALERT

4 November 2013

REVISED BROAD-BASED BLACK ECONOMIC EMPOWERMENT CODES OF GOOD PRACTICE

On 11 October 2013, the final and long-awaited revised Codes of Good Practice (revised Codes) were published in the Government Gazette.

The revised Codes make a number of changes to the Broad-Based Black Economic Empowerment (B-BBEE) Codes of Good Practice which were published in February 2007 (original Codes), some of which had been proposed in the draft revised Codes published last October, and some of which we have not had sight of before. This alert focuses on some of the more material changes that have been introduced.

Commencement of revised Codes and status of the original Codes

The revised Codes will come into operation 12 months after the date of publication, and they provide that until such date, a measured entity can elect to use the generic scorecard set out in the revised Codes or the original Codes for measurement purposes. Upon termination of this period, B-BBEE compliance will be measured in accordance with the revised Codes and not the original Codes. Other than for obscure references in the revised Codes to the repeal of certain statements under the original Codes, there is no express indication in the revised Codes whether the original Codes have been repealed in their entirety or whether part of the original Codes has been amended by the revised Codes. The draft revised Codes were structured as proposed amendments to specific sections of the original Codes but the final revised Codes have been published as a stand-alone document.

The final revised Codes omit Statement 003 (Guidelines for developing Transformation and Sector Charters) and Statement 004 (Scorecards for Specialised Enterprises) of Code Series 000, and Statement 102 (Recognition of the Sale of Assets) and Statement 103 (The Recognition of Equity Equivalents for Multinationals) of Code Series 100 in their entirety and do not contain equivalent provisions. The Department of Trade and Industry (DTI) issued a press statement on 11 October 2013 confirming that Statements 003 (Guidelines for developing Transformation and Sector Charters), 004 (Scorecards for Specialised Enterprises) and 103 (The Recognition of Equity Equivalents for Multinationals) will remain in effect until amended. The DTI advised that the intention is to release such revised statements "*in the near future*". The press statement does not make mention of Statement 102 (Recognition of the Sale of Assets), and its status remains unclear. We hope that the DTI will formally clarify this in due course.

Unfortunately, the revised Codes again suffer from poor drafting as was the case in the original Codes and will present a number of interpretative difficulties.

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Revised elements of B-BBEE of the generic scorecard

As contemplated in the draft, the final revised Codes have merged the elements of Management Control and Employment Equity into a single element referred to only as Management Control, and the elements of Preferential Procurement and Enterprise Development into a single element referred to as Enterprise and Supplier Development. The revised Codes provide for five elements, as opposed to the seven that were provided for in the original Codes, which are weighted as follows (and which do not differ from those proposed in the draft revised Codes) -

Element	Weighting	New Code series
Ownership	**25** [up from 20]	100 (as before)
Management Control	**15** [up from 10 but incorporates Employment Equity]	200 (revised)
Skills Development	**20** [up from 15]	300 (revised)
Enterprise and Supplier Development	**40** [up from 35 which was the combined total of Preferential Procurement and Enterprise Development previously]	400 (revised)
Socio-Economic Development	**5** [as before]	500 (revised)

Revised thresholds for contributor status scoring

The number of qualification points for each of the B-BBEE contributor status levels below level one has been increased in accordance with the proposal in the draft revised Codes as follows:

B-BBEE Contributor Status	Qualification	B-BBEE recognition level
Level One Contributor	≥ 100 points on the G/Scorecard **[as previously]**	135%
Level Two Contributor	≥ 95 but ‹ 100 points on the G/Scorecard **[Up 10 points]**	125%
Level Three Contributor	≥ 90 but ‹ 95 points on the G/Scorecard **[Up 15 points]**	110%
Level Four Contributor	≥ 80 but ‹ 90 points on the G/Scorecard **[Up 25 points]**	100%
Level Five Contributor	≥ 75 but ‹ 80 points on the G/Scorecard **[Up 20 points]**	80%
Level Six Contributor	≥ 70 but ‹ 75 points on the G/Scorecard **[Up 25 points]**	60%
Level Seven Contributor	≥ 55 but ‹ 70 points on the G/Scorecard **[Up 15 points]**	50%
Level Eight Contributor	≥ 40 but ‹ 55 points on the G/Scorecard **[Up 10 points]**	10%
Non-compliant Contributor	‹ 40 points on the G/Scorecard **[Up 10 points]**	0%

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It will generally be more difficult for enterprises to achieve and possibly retain their current (and possibly, favourable) B-BBEE contributor status ratings under the revised Codes. For example, an entity that has obtained a level four contributor status rating under the original Codes will have scored between 65 and 75 points. If such score does not increase prior to its next verification under the revised Codes, that measured entity's contributor status will drop to either a level six or a level seven.

New Concept – Minimum Threshold Requirements for Ownership, Skills Development, and Enterprise and Supplier Development

The final revised Codes retain the classification of the elements of Ownership, Skills Development and Enterprise and Supplier Development as priority elements for which there are minimum compliance targets and for which a penalty for non-compliance will be imposed. Large enterprises are required to meet the minimum thresholds for all three priority elements while qualifying small enterprises (QSEs) are required to comply with the minimum thresholds for Ownership and one other priority element.

If either a large enterprise or a QSE fails to meet the minimum thresholds in respect of **any** of the applicable priority elements the non-compliance penalty will be a reduction in its B-BBEE contributor status level by **one** level (and not two levels as proposed in the draft revised Codes). The revised Codes clarify that an entity's compliance with the minimum thresholds will be assessed in each year of verification and that penalties will not be carried through from one year to the next.

The minimum thresholds for the priority elements are as follows:

Ownership: a measured entity must achieve a minimum of 40% of the 'Net Value' points based on paragraph 4 of Annexure 100(E) to Code Series 100 of the revised Codes (ie 40% of the 8 points being 3.2 points). The original intent behind the latter Annexure was to encourage the achievement of debt free 25% Black equity in enterprises graduated over a period of 10 years. Traditionally, a lot of attention has been paid to structuring and funding of B-BBEE transactions in such a way that the graduated net value targets specified in paragraph 4 are achieved in order for a measured enterprise to score optimally over a 10 year period on this section of the Ownership element of the original Codes. It is now going to be imperative to pay more attention to debt funding structures because if the these structures do not at least allow for the value of the equity to exceed the carrying value of the debt in question and accordingly meet the relevant minimum requirements, they will be found wanting.

The requirement that a measured entity will need to achieve a minimum of 40% of the 'Net Value' points determined on the basis of paragraph 4 of Annexure 100(E) to Code Series 100 of the revised Codes or have a penalty reduction in their B-BBEE contributor level imposed will have the effect of:

- compelling firms who have not done Black equity deals at all, or who have not done the targeted 25% equity deal, to consider doing them to ensure that they are able to meet the targeted minimum of 40% of the net value points and;
- compelling firms who have done Black equity deals that are funded to ensure that the funding is retired at a rate sufficient to ensure that the measured entity achieves the targeted minimum of 40% of the net value points.

- **Skills Development:** a measured entity must achieve a minimum of 40% of the targets set out in the Skills Development scorecard. As indicated below, these targets have also been adjusted and new concepts introduced in relation to the measurement of and determination of compliance.
- **Enterprise and Supplier Development:** a measured entity must achieve a minimum of 40% of each of the targets set out in paragraph 2.1 (preferential procurement component of this element), paragraph 2.2 (the supplier development component of this element) and paragraph 2.3 (the enterprise development component of this element), excluding the bonus points applicable under each such component, of the Enterprise and Supplier Development scorecard. This is a deviation from the draft revised Codes which required that a measured entity must only achieve a minimum of 40% of the targets set out in paragraphs 2.1.1 (a target of 80% for B-BBEE procurement from all Empowering Suppliers spend based on the B-BBEE recognition levels as a percentage of total measured procurement spend); 2.2.1 (a target of 2% of NPAT for annual value of all Supplier Development Contributions made by the measured entity); and 2.2.2 (a target of 1% of NPAT on the annual value of Enterprise Development contributions and sector specific programmes made by the measured entity).

Other revisions: EMEs and QSEs

The revised Codes have changed the turnover thresholds for the classification of measured enterprises as follows:

- the threshold for exempt micro enterprises (EMEs) will be changed from an annual turnover of R5 million to R10 million or less;

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- the threshold for QSEs will be changed from an annual turnover of between R5 million and R35 million to between R10 million and R50 million; and

- the threshold for large enterprises will be changed from an annual turnover of more than R35 million to more than R50 million.

EMEs will continue to benefit from a deemed level four B-BBEE contributor status, but EMEs that are at least 51% Black owned will now qualify for a level two B-BBEE contributor status (under the original Codes they qualify for a level three contributor status) while EMEs that are 100% Black owned will qualify for a level one B-BBEE contributor status. The same principles apply to so called 'start-up enterprises' and QSEs. In addition, EMEs *and* QSEs will only be required to provide a sworn affidavit on an annual basis confirming their annual turnover and level of Black ownership to obtain measurement under the revised Codes, and will be relieved form the financial burden of procuring verification certificates or confirmations from competent persons in respect of their statuses. It seems remarkable that companies with annual turnovers up to R50 million will effectively be excused from complying with the revised Codes simply because they are at least 51% Black owned.

The term '51% Black owned' is defined as an entity in which (a) Black people hold at least 51% of the exercisable voting rights; (b) Black People hold at least 51% of the economic interest; *and* (c) has earned all the points for Net Value. The latter requirement means that a QSE or EME whose voting rights and economic interest are held in excess of 51% by Black people will not qualify for the deemed level two B-BBEE contributor status unless the total debt associated with the acquisition of their shareholding has been discharged so that the company is able to earn all the Net Value points on the scorecard. There is no similar definition for the term '100% Black owned' so the Net Value limitation does not apply to a 100% Black owned QSE or EME.

The revised Codes also provide that 'start-up enterprises' must submit a QSE scorecard when tendering for any contract, or seeking any other economic activity covered by s10 of the B-BBEE Act, with a value higher than R10 million but less than R50 million. The generic scorecard should be used for contracts over R50 million. The original Codes contained the same wording save that the threshold for using the QSE scorecard was between R5 million and R35 million and the threshold for using the generic scorecard was over R35 million. As discussed, below, the revised Codes do not contain a QSE scorecard, which makes it difficult to understand how this requirement will be met.

Other revisions: QSE Scorecard

In contrast to the original Codes, QSEs will be required to comply with **all** the elements contained in the revised Codes. The revised Codes make reference to a QSE scorecard in various places and defines the QSE scorecard as the QSE scorecard referred to in statement 000. Statement 000 does not actually contain a QSE scorecard, nor does one appear anywhere else in the revised Codes. It seems that the QSE scorecard has been erroneously omitted from the revised Codes. In a presentation to parliament on 30 October 2013, the Director General of the DTI indicated that the QSE scorecard will be revised prior to the date on which the revised Codes become operational, during what is referred to as a second phase of refinement of the Codes.

Status of sector codes

To the extent that a sector code in respect of a particular industry has been issued in terms of s9 of the B-BBEE Act, No 53 of 2003 a measured entity that falls within such industry may only be measured for compliance in accordance with the applicable sector code. The contents of each sector code must be analysed to determine to what extent the revised Codes may be applicable to the relevant sector and to what extent and when the sector code will have to be amended to align it with the revised Codes.

Other revisions: Ownership

In relation to the measurement principles for Ownership, the revised Codes state that a measured entity that applies the modified flow-through principle cannot benefit from the exclusion principle, and a measured entity using the exclusion principle to mandated investments cannot benefit from the modified flow-through principle. The revised Codes have also increased the level of participation to apply the modified flow-through principle from more than 50% (as set out in the original Codes) to at least 51%. The difference is marginal but if an ownership deal of more than 50% but less than 51% has been done, it will no longer benefit from the modified flow-through principle. This principle has also been carried through to the provisions regarding private equity funds.

The measurement of the B-BBEE status of private equity funds has been clarified and expanded. In particular the B-BBEE status of a private equity fund will be measured in relation to the fund manager and not the fund itself, as described in the original Codes.

One of the criticisms levelled at the original Codes as it relates to private equity investments was that it was practically difficult to comply with the requirements insofar as these investments could only be recognised if, *inter alia*, investments are made into existing Black owned enterprises. The revised Codes attempt to address this by allowing the private equity fund

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manager to facilitate such direct Black shareholding at the time of entering into the relevant transaction should the target company not meet the required 25% Black shareholding.

To meet the target of investing 51% of the funds under management into 25% Black-owned companies, private equity fund managers are now allowed to achieve this target incrementally over a period of nine years; this target starting at 5% in year one. The commencement date of this nine year period is 11 October 2014 and the date of establishment of a new fund.

The revised Codes have introduced the following additional requirements for broad-based ownership schemes which were previously only applicable to employee share ownership schemes:

- the constitution of the scheme must define the participants and the proportion of their claim to receive distributions;
- a written record of the name of the participants or the use of a defined class of natural person satisfies the requirement for identification;
- a written record of fixed percentages of claim or the use of a formula for calculating claims satisfies the need for defining proportion of benefit;
- the fiduciaries of the scheme must have no discretion on the terms set out in Annexure 100 (B) of the revised Codes;
- the constitution, or other relevant statutory documents, of the scheme must be available, on request, to any participant in an official language in which that person is familiar; and
- the scheme fiduciaries must present the financial reports of the scheme to participants yearly at an annual general meeting of the scheme.

Broad-based Ownership schemes (BBOS) will have to clearly define the intended beneficiaries and the extent of benefits that they will receive from the BBOS.

The revised Codes has also introduced an additional category for trusts, namely the 'Family Trust' and provides that the qualification criteria for the recognition of family trusts are as follows –

- the trust deed must define the beneficiaries and the proportion of their entitlement to receive distributions;
- a written record of the names of the beneficiaries or the use of a defined class of natural person satisfies the requirement of defining beneficiaries;
- use of a formula for calculating entitlement satisfies the need for defining proportion of benefit;
- only the trustees must have discretion on the above mentioned terms; and
- on winding up or termination of the trust, all accumulated economic interest must be transferred to the beneficiaries or to any entity representing the interest of the participants or class of beneficiaries.

The provisions for trusts have not been amended or altered, so that any other type of trust would be required to meet such requirements for ownership purposes.

Other revisions: management

The Management Control scorecard proposes to measure, as separate criteria, the exercisable voting rights of all Black board members, the exercisable voting rights of Black female board members, exercisable voting rights of all executive Black board members, the exercisable voting rights of Black female executive board members, the exercisable voting rights of Black other executive management and the exercisable voting rights of Black female other executive management. Other executive management positions include all executive management that do not serve on the board, such as the human resources executive and the transformation executive. As contemplated in the draft revised Codes, the concept of the 'Adjusted Recognition for Gender' has been removed and the measurement categories that are currently included in the Employment Equity scorecard have been moved to the Management Control scorecard. There are separate criteria to measure the Black females employed within senior management, middle management and junior management.

Controversially, the revised Codes retain a requirement that for Management Control scoring purposes account must also be taken of the different racial subgroups (ie Africans, Coloureds and Indians). A new formula has been introduced for purpose of the calculation of Management Control scoring and this formula now requires the racial subcategories to be used in the calculation. To ensure 'equitable representation' the formula compels one to make reference to the compliance targets set out in the regulations of the Employment Equity Act, No 55 of 1998 and Commission on Employment Equity Report. As far as we are aware, no such compliance targets have been set as yet which makes this formula difficult to apply. Both the Employment Equity Amendment Bill, which Bill sets out the proposed amendments to the Employment Equity Act, and the Commission on Employment Equity Report refer to the demographic profile of the national and regional economically active population. In terms of the Employment Equity Amendment Bill, the Minister may by regulation specify the

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circumstances under which an employer's compliance with the Employment Equity Act should be determined with reference to the demographic profile of either the national economically active population or the regional economically active population. The revised Codes are however silent as to whether the demographic profile of either the national economically active population or the regional economically active population must be utilised in the formula for purposes of the calculation of Management Control scoring. The Director General's presentation on 30 October 2013 indicated that it could be either national or regional demographics but it is not clear how this will be implemented in practice. What is more, the implication is that it will not matter how many Black people overall are in the relevant management positions as what will matter is whether sufficient numbers of the (to be) prescribed racial category groups are catered for. Over subscription in one category will not yield any benefit and in fact may be detrimental to the extent that this is at the expense of representation in any of the other racial categories.

Other revisions: Skills Development

The revised Codes also amend the Skills Development scorecard by removing the concept of the 'Adjusted Recognition for Gender'. There are no subcategories in the scorecard measuring the percentage of Black females in the different skills development criteria. The total number of points on this scorecard has been adjusted to twenty points from the current fifteen and the compliance targets have all adjusted, save in respect of the element relating to skills development expenditure on learning programmes specified in the learning programme matrix for Black employees, which compliance target has been retained at 0.3%. The compliance target for skills development expenditure specified in the learning programme matrix for Black people has been increased from 3% under the original Codes to 6%. This compliance target will include any external training expenditure for unemployed Black people. Additional elements have been introduced including so called learnerships, apprenticeships and internships and there are also points on offer for the number of Black people participating in learnerships, apprenticeships and internships and the number of unemployed Black people participating in training specified in the learning programme matrix. Five additional bonus points have been created for the number of Black people absorbed into the applicable industry or measured entity at the end of learnership programmes.

In terms of the revised Codes, mandatory sectoral training (ie health and safety training for the construction sector) will not qualify as skills development contribution whereas training outside the country but in line with the Learning Programme Matrix contemplated in Annexure 300 (A) will be measurable provided it complies with the South African Qualification Authority requirement for recognition. Under the revised Codes, a measured entity need not be in compliance with the requirements of the Skills Development Act, No 97 of 1998 and the Skills Development Levies Act, No 9 of 1999 to score points on this element of the scorecard.

As indicated prior, the Skills Development Element is one of the priority elements so a minimum compliance of 40% of the targets must be achieved to avoid the imposition of the penalty.

Also, as is the case with the Management Control scorecard, the Skills Development scorecard requires the relevant targets to be further broken down into racial subcategories. Similar wording as quoted above in relation to the Management Control scorecard is contained here referring to the weighting of the different racial subgroups. A similar formula is also provided which again takes into account the racial subgroups.

Other revisions: Enterprise and Supplier Development

The new Enterprise and Supplier Development scorecard increases the targets for the measurement criteria currently contained in the Preferential Procurement scorecard of the original Codes. In amalgamating the Enterprise Development scorecard into this new Enterprise and Supplier Development scorecard the target has been split into 2% of NPAT for annual value of all Supplier Development contributions made by the measured entity and 1% of NPAT for annual value of all Enterprise Development contributions and sector specific programmes made by the measured entity.

Points for B-BBEE procurement spend can now mainly only be claimed if such spend is on Empowering Suppliers. An Empowering Supplier is defined as a B-BBEE compliant entity which is a 'good citizen South African entity', complies with all regulatory requirements of the country and, if it is a large enterprise, complies with at least three, or if it is a QSE, complies with at least one, of the following criteria:

- at least 25% of cost of sales excluding labour cost and depreciation must be procured from local producers or local suppliers in South Africa – for the service industry, labour costs are included but capped at 15%;
- 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; and
- at least 12 days per annum of productivity deployed in assisting EME and QSE beneficiaries to increase their operation or financial capacity.

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The term Empowering Supplier creates a myriad of concerns. It is not clear what a 'good citizen' is in the context or, if that term is intended to be clarified by the words 'complies with all regulatory requirements of the country'. The criteria for Empowering Suppliers are quite restrictive and it is likely that a considerable number of suppliers will not be able to comply with these requirements, notwithstanding that they may have significant levels of B-BBEE compliance. A supplier will have to be verified as an Empowering Supplier well in advance of a measured entity's verification date. Suppliers must expect that their customers will request such confirmations by the first operation date of the revised Codes so will have to undertake such verifications some time prior to 11 October 2014.

EMEs and start-up enterprises will automatically be recognised as Empowering Suppliers.

Enterprise and Supplier Development are two separate concepts with the former being analogous to Enterprise Development as understood in the original Codes and the latter, Supplier Development, being a new concept aimed at local supplier development, for which the lion's share of the points on offer are allocated. Beneficiaries of Enterprise Development and Supplier Development are restricted to EMEs and QSEs which are at least 51% Black owned or 51% Black women owned.

As indicated above Enterprise and Supplier Development is a priority element so 40% of the targets have to be achieved to avoid the penalty B-BBEE status downgrade.

Measured entities are encouraged to develop an Enterprise Development plan and a Supplier Development plan for qualifying beneficiaries. This plan must include clear objectives, priority interventions, key performance indicators and a concise implementation plan with clearly articulated milestones.

There is also a new list of examples of monetary and non-monetary contributions and Enterprise and Supplier Development contributions.

Contrary to the proposal in the draft revised Codes that measured entities would no longer be permitted to exclude certain imported goods and services from total measured procurement spend (TMPS), the revised Codes have retained such exclusion as provided for in the original Codes but have now provided that in the case of imported goods for which there is no local production, the exclusion will only apply if an Enterprise Development and Supplier Development plan has been developed and implemented.

Other revisions: Socio Economic Development

The new Socio Economic Development Scorecard retains the existing compliance target of 1% of NPAT and 5 weighting points. The draft revised Codes deleted the requirement to apply an indicative profit margin where the measured entity does not make a profit and made provision that Socio Economic Development contributions must benefit Black people 100%. The revised Codes have reverted to the wording catered for in the original Codes.

Unlike the original Codes which provided for a cumulative calculation of socio-economic development contributions, the revised Codes make provision for an annual calculation.

Should you require any advice on the provisions of the revised Codes please feel free to contact us, as per our details listed on the back cover herewith.

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