

Go with the

Flow



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Murray Chabant is the Chief Executive Officer at the Signa Group, specialising in the implementation of Private Equity as well as Employee and Broad-Based Ownership structures. His solid track record stems from implementing sustainable and financially feasible Ownership structures within multinational organisations, as well as large private and family-owned businesses. His unique ability to engage with stakeholders and communities alike supports organisations in driving their transformation agendas successfully. His fervour to instil meaningful transformation in the South African business arena more than equips him to guide strategies aligned to best practice and sustainable outcomes.

Setting the Scene

This article will unpack the outcomes of applying the 'Flow-Through' Principle (FTP) as opposed to the 'Modified Flow-Through' Principle (MFTP) in determining the 'Black' Ownership recognition of an organisation. It will further highlight the unintended consequences and challenges resulting from an incorrect application by EMEs and QSEs, claiming more than 51% 'Black' Ownership. Moreover, this article will address the issues facing organisations when supporting Enterprise Development or Supplier Development Beneficiaries when the MFTP is incorrectly applied.

The organisational structure of ABC Trading is a typical ownership structure of many South African organisations, which will set the scene as a base for this article. ABC Trading was established as a result of pressure on a large retailer, Cashco (Pty) Ltd, that needed to provide its customers with more favourable B-BBEE credentials, specifically in the area of 'Black' Ownership. Instead of selling shares to a 'Black' Shareholder, Cashco decided to embrace the Spirit of B-BBEE and set up ABC Trading as a 51% 'Black'-owned organisation to supply a portion of its products to its most B-BBEE sensitive customers. Cashco went further in 'embracing' the Spirit of B-BBEE by providing ABC Trading with an Enterprise Development loan of R5m to get the business started.

Flow-Through
Principle
VS
Modified
'Flow-Through'
Principle

Illustration of Cashco (Pty) Ltd Ownership structure.		'Black' Ownership	Non 'Black' Ownership
Nkosi Family Trust	A Trust set up for the benefit of Mr Nkosi and his descendants. He is currently a 90% Beneficiary of the Trust. The Red Cross is a 10% Beneficiary of the Trust. The Trust meets the Rules for Family Trusts in Annexure 100 (D) in the Codes of Good Practice (Generic Codes).	90%	10%
XYZ Holdings	An EME that is 90% owned by the Nkosi Family Trust and 10% owned by Cashco. It earns management fees from its investment in LMN Merchants of R6m per annum. XYZ Holdings is more than 51% 'Black'-owned and qualifies as an Enterprise Development or Supplier Development Beneficiary. The business confirms its 'Black' Ownership and B-BBEE status by presenting an Affidavit.	90%	10%
LMN Merchants	A Generic Enterprise that is 65% owned by XYZ Holdings - therefore a subsidiary of XYZ Holdings and 35% owned by Cashco. It has an annual revenue in excess of R100m from wholesaling products, which includes a portion of sales to its subsidiary ABC Trading. A SANAS accredited verification agency verifies the business.	65%	35%
ABC Trading	In its first year of operation, ABC Trading issued an Affidavit as a Start-up Enterprise. Now in its second year of operating, ABC Trading has increased its annual revenue to R35m, therefore qualifies as a QSE. It is 51% owned by LMN Merchants - therefore a subsidiary of LMN Merchants - and 49% owned by Cashco. The business confirms its 51% 'Black' Ownership and Level 2 B-BBEE status by presenting an Affidavit.	51%	49%

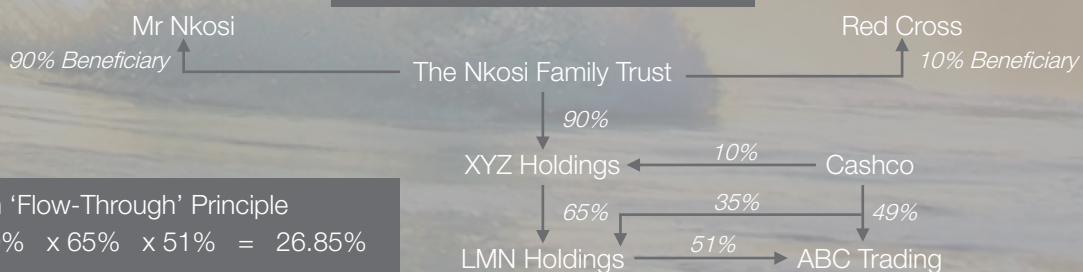
What is the 'Flow-Through' Principle? (FTP)

In the 2007 and 2013 Amended Codes of Good Practice the general rule for measuring 'Black' Ownership recognition is on the basis of the FTP.

The FTP traces and measures effective Ownership until it ultimately ends in the hands of a 'Black' natural person. In a complex and multi-tiered structure such as the ownership structure of ABC Trading, the FTP measures the Rights of Ownership of a 'Black' natural person as it flows through each juristic entity. It applies across every tier of Ownership in a multi-tiered chain until it ends with a 'Black' natural person holding the Rights of Ownership.

Chart A

Flow-Through Principle



Calculation 'Flow-Through' Principle
 $90\% \times 90\% \times 65\% \times 51\% = 26.85\%$

Chart A illustrated on the previous page demonstrates the FTP Rights of Ownership of 'Black' Shareholders in ABC Trading as it 'flows through' from Mr Nkosi through various juristic entities - the trust and its subsidiaries - until ending with his effective shareholding in ABC Trading. The 'Black' Ownership of ABC Trading is calculated as:

$$100\% \times 90\% \times 90\% \times 65\% \times 51\% = 26.85\%$$

When applying the FTP ABC Trading's 'Black' Ownership Recognition is 26.85%.

What is the 'Modified Flow-Through' Principle? (MFTP)

The MFTP provides for the modification of 'Black' Ownership such that where a juristic entity is 51% or more 'Black'-owned it may be treated as if it were 100% 'Black'-owned. This principle can be applied at any tier in an ownership structure provided it is only used once in the entire structure and the juristic entity is either a:

- > 'B-BBEE Owned Organisation': being a juristic person, having shareholding or similar members interest, that is B-BBEE controlled, in which 'Black' Participants enjoy a right to 'Economic Interest' that is at least 51% of the total rights measured, using the FTP.

OR

- > 'B-BBEE Controlled Organisation': a juristic person, having shareholding or similar members interest, in which 'Black' Participants enjoy a right to Exercisable 'Voting Rights' which are at least 51% of the total of such rights measured using the FTP.

The MFTP enhances the measurement of 'Exercisable Voting Rights' as per 2.1.1 in Code 100 of the Ownership scorecard and 'Economic Interest' to which 'Black' People are entitled as per 2.2.1 in Code 100 of the Ownership scorecard. However, this enhancement does not apply to the 'Net Value' calculation.

Put simply, anywhere in a corporate structure where there is 51% or more 'Black' Shareholding in a B-BBEE-owned or Controlled organisation, 100% 'Black' Ownership is recognised for 'Voting Rights' and 'Economic Interest'. This enhancement cascades through the remaining 'Black' Ownership tiers, enhancing the Ownership points and 'Black' Ownership percentage on an organisation's scorecard. However, as previously stated, it is essential to note that the MFTP can only be applied once in the entire corporate structure.

Chart B

'Modified Flow-Through' Principle



Calculation 'Modified-Flow- Through' Principle

90% x 90% x 65% x 51%

= 81% x 65%

= 52.65% (Applying MFTP = 100%)

= 100% x 51% = 51%

Chart B demonstrates the MFTP Rights of Ownership of 'Black' Shareholders of ABC Trading which is calculated as: 51%

A comparison of results applying both principles in ABC Trading's structure:

ABC Trading applying FTP	ABC Trading applying MFTP
26.85% 'Black' Ownership Recognition	51% 'Black' Ownership Recognition

This outcome illustrates the difference in 'Black' Ownership Recognition based on two well-established principles provided for in the Generic Codes, both of which serve a purpose in the broader scheme of B-BBEE. However, the application of the MFTP, especially by EMEs and QSEs that claim Enhanced Recognition, has led to some unintended consequences.

Why was the MFTP introduced in the first place?

A significant reason for the inclusion of the MFTP in the Generic Codes was to enable 'Black' Entrepreneurs to raise equity finance - or risk capital - from 'non-Black' Investors who invest alongside 'Black' Investors without diluting the 'Black' Ownership recognition of an organisation. Essentially the MFTP negates the effect of a 'non-Black' Investor, providing the 'Black' Investor retains control of the 'Voting Rights' and 'Economic Interest' in an organisation.

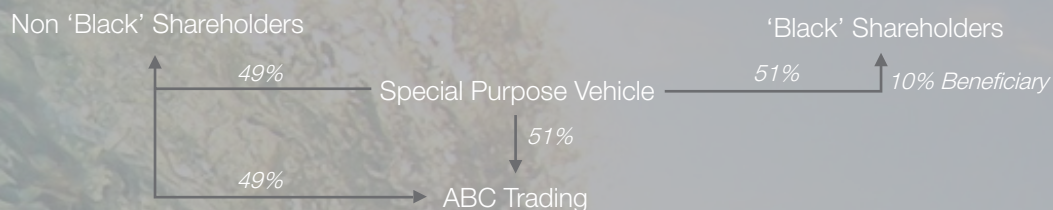
In this case, Cashco was able to invest 10% in XYZ Holdings, 35% in LMN Merchants and 49% in ABC Trading, implying that its effective economic interest in ABC Trading is 67,87%. Yet by applying the MFTP ABC Trading remains 51% 'Black'-owned on its scorecard.

Is there an unintended consequence to the MFTP?

As with most things in life, there are always ups and downs. Ingenious structuring of the MFTP has led to adverse outcomes or unintended consequences. Although a prevalent structure, the diagram below highlights how the MFTP could create an opportunity to potentially circumvent the substance of B-BBEE.

Chart C

Modified Flow-Through' Principle - Typical Vendor Finance Model -



The net effect of the above illustration, using the MFTP, is that ABC Trading is reflecting 51% 'Black' Ownership on its scorecard, when in fact the 'non-Black' Shareholders have an effective 73,99% shareholding which is calculated as:

49% direct shareholding + 49% x 51% shareholding via a Special Purpose Vehicle (SPV) = 73,99% effective shareholding in ABC Trading. Using the FTP with the same structure, the 'Black' Shareholders would hold 26,01% or 51% x 51% shareholding via SPV in ABC Trading. Primarily, using an SPV and applying the MFTP takes the same 'Black' shareholding of the SPV from 51% 'Black'-owned to 100% 'Black'-owned. In and of itself, there is nothing wrong with this structure and it is commonly used in vendor financed transactions.

However, a problem arises when ABC Trading uses the Enhanced Recognition criteria afforded to 51% 'Black'-owned organisations, by claiming Enhanced Recognition of a Level 2 Status and merely issues an Affidavit to this effect. The result is that, on paper, ABC Trading is a 51% 'Black'-owned QSE. As indicated earlier, Cashco opted to use ABC Trading as an Enterprise Development Beneficiary for its own B-BBEE scorecard and credentials. However, this contradicts the substance of the Generic Codes. Why? Well, for every R100 Cashco contributes to ABC Trading for Enterprise Development, Cashco would indirectly benefit R67,87.

While it seems absurd that Cashco can benefit from its own Enterprise Development contribution to ABC Trading, the legislation, as it is drafted, allows for this eventuality. However, verification agencies have identified this practice as a circumvention and generally reject such contributions as they do not align with the spirit of B-BBEE. Nonetheless, it can be challenging to identify such unintended consequences when the only evidence required to prove 'Black' Ownership status for EMEs and QSEs is an Affidavit. When ABC Trading took their Affidavit to be notarised at the police station by a Commissioner of Oaths, the officer did not attest to the correctness of the Affidavit but merely confirmed that the deponent understood the contents and agreed to swear to the correctness of the Affidavit.

Consequently, it is becoming common practice for verification agencies to request proof of 'Black' Ownership from Enterprise Development or Supplier Development Beneficiaries in the form of share registers, share certificates, shareholder agreements and Memoranda of Incorporation. These documents would determine the exact ownership credentials of an EME or QSE without placing reliance exclusively on an Affidavit presented. Inadvertently, this puts the burden of proof on EMEs or QSEs, which was never intended by the legislator.

Still, the unintended consequences - and often abuse - of the MFTP elicited a reaction from the B-BBEE Commission. The B-BBEE Commission Practice Guide 1 of 2017 'Enhanced Recognition Status for EMEs and QSEs through the application of the MFTP' outlines the expectations of the B-BBEE Commission'. (While a Practice Guide is issued as a non-binding guide to assist with interpretation and ensure consistency in the application of the Act, it does set out the approach that the B-BBEE Commission is likely to take on any such matter).

Page 3 of the Practice Guide states, "The introduction of this intervention brought about an exception to the extent to which organisations can rely on the MFTP to calculate their 'Black' Ownership. It is our view that this limits the calculation of 51% and 100% 'Black' Ownership for EMEs and QSEs only through the application of the FTP, in line with the B-BBEE objectives outlined in section 2 of the B-BBEE Act. While we do recognise that the Codes have not explicitly provided limitations for the application of the MFTP in claiming Enhanced Recognition for 'Black'-owned and controlled EMEs and QSEs ... (the Commission)...hereby concludes that the MFTP cannot be used to benefit from the Enhanced Recognition status reserved for 51% and 100% 'Black'-owned EMEs and QSEs. Any contrary advice is a misrepresentation of an organisation's B-BBEE status, which is an offence in terms of section 130 (1) (a) of the Act." Please see page 38.

While the Commission's view is clear, the application of the MFTP by many organisations, like ABC Trading, claiming Enhanced Recognition and a Status Level 2, 51% 'Black'-owned, continues. The result - whether knowingly or unknowingly - is that organisations like Cashco are making Enterprise Development or Supplier Development contributions to organisations within their ownership structures that on the face of it are 51% 'Black'-owned. Subsequently, Cashco's Enterprise Development contributions to ABC Trading not only allows them to benefit R67,87 per R100 contribution indirectly, but claim up to 5 points for Enterprise Development. More in-depth scrutiny is, therefore, necessary to ensure that host/beneficiary relationships like Cashco and ABC Trading are identified to ensure contributions are allocated in the spirit in which they were intended.

Enter Gazette #42469 ...

The addition of the five words that appear innocuously in this Gazette remove any doubt as to how to measure the 'Black' Ownership of qualifying Enterprise Development or Supplier Development Beneficiaries. For organisations like Cashco, the five words might remove 5 points from their scorecard, which could consequently reduce their overall scorecard and result in a loss of up to two Status Levels due to:

- > The Enterprise Development contribution not being recognised, consequently removing 5 points from this element; and
- > Not meeting the Sub-minimum Requirement for Enterprise Development resulting in a one Status Level penalty.

Sections 3.7 and 3.9 of Gazette #42496 refers:

3.7 | Beneficiaries of Supplier Development or Enterprise Development are EMEs, QSEs or *Generic Entities which are at least 51% 'Black'-owned or at least 51% 'Black' woman-owned utilising the Flow-Through Principle. However, in terms of Generic Entities, this is based on the provision that at the first instance of receiving assistance from the Measured Entity, it was identified that such suppliers were EMEs or QSEs. This recognition for Generic Entities will only be allowed for five years from the time of initially receiving assistance from the Measured Entity.

3.9 | B-BBEE Procurement Spend from *Generic Entity Suppliers who are at least 51% 'Black'-owned or at least 51% 'Black' woman-owned utilising the Flow-Through Principle is recognised under Point Indicator 2.1.2 and 2.1.3 of the Enterprise and Supplier Development Scorecard. However, this is based on the provision that at the first instance of procuring goods and services, it was identified that such suppliers were EMEs or QSEs. This recognition for Generic Entities under Point Indicator 2.1.2 and 2.1.3 will only be allowed for five years from the time of initially procuring goods and services from such suppliers.

** The glaring difference between the Codes and Gazette #42469 is that the amendments in both paragraph 3.7 and 3.9 introduce Generic Entities as Beneficiaries. Generic Entity Suppliers are entities with an annual turnover that exceeds R50m. This, in itself, is a significant shift that will be addressed in the next edition.*

For organisations that have always applied the FTP approach to identify whether their Enterprise Development or Supplier Development Beneficiaries qualify as Beneficiaries will not need to change to their current strategy.

However, the amendments in this Gazette immediately disallow organisations like Cashco from having Beneficiaries like ABC Trading as their Enterprise Development Beneficiary. The result of this will only become apparent at Cashco's next B-BBEE Audit when they are not able to claim any contributions made to ABC Trading.

To align with the amendments in Statement 400, both Enterprise Development and Supplier Development Beneficiaries must be 51% directly 'Black'-owned by applying the FTP only. Only Beneficiaries that used the FTP will qualify as Enterprise Development or Supplier Development Beneficiaries.

What are the unintended consequences of Gazette #42496?

There are immediate consequences for Cashco - or any other such organisations - for accepting the ownership credentials presented by ABC Trading in their Affidavit at face value.

It is evident that the historic practice of relying totally on the information provided in an Affidavit can no longer suffice. Organisations like Cashco, looking to contribute to Enterprise Development and Supplier Development, will have to drill down into the Ownership credentials of potential Beneficiaries to ensure that they are in fact 51% or more 'Black'-owned through the application of the FTP.

The unintended consequences for EMEs and QSEs like ABC Trading are that Cashco may withdraw their Enterprise Development support and call on their loan. Other significant implications for ABC Trading may be the cancellation of guarantees or preferential credit terms, support grants, free rental or training and development provided to them by Enterprise Development contributors.

For Beneficiaries like ABC Trading, it may be uncomfortable to have potential contributors digging into their Ownership structure. However, there is currently no other mechanism to determine the real Ownership structure of 'Black'-owned organisations like ABC Trading.

A remedy would be an independent 'Ownership Review' or Report – otherwise called an Ownership Certificate – generated by SANAS accredited verification agencies. Although this would add to the cost of compliance for organisations like ABC Trading, it would provide solid Ownership credentials for both the beneficiaries and contributing organisations alike.

The result of Gazette #42496 is that the opinion of the B-BBEE Commission on the recognition of the MFTP expressed in 2017 has now found legal and practical expression in the treatment of Enterprise Development or Supplier Development contributions as per paragraphs 3.7 and 3.9 of Code 400. The Gazette subsequently forces qualifying Beneficiaries to rethink their Ownership structures as Affidavits will no longer suffice to support contribution claims made by organisations.