OWNERSHIP

CHOOSE YOUR PRINCIPLE WISELY

In issue 23 of TFM Magazine, we unpacked definitions linked to the Ownership Scorecard published as Gazette #36928, an amendment to the Generic Codes of Good Practice (Codes). In this overview, emphasis was on potential valuation methodologies available. The chosen methodology used to value an organisation is critical to the Net Value component, which awards the most points on the Ownership Scorecard, not forgetting the Discounting Principle for not meeting the 40% sub-minimum requirement.

In this issue, we delve into the Ownership Scorecard, focusing on the Exclusion Principle and its effect during a B-BBEE Verification. To fully articulate this principle, one must firstly recognise the difference between a 'Form' of Ownership versus a 'Principle' of Ownership when applying the Exclusion Principle during a B-BBEE Verification.

The ability to recognise what differentiates a 'Form' vs a 'Principle' of Ownership lies in the definitions held in Schedule 1, published as Gazette # 42496 in 2019. It is the point of reference for interpretations and definitions within the Codes. Interpretation of the Codes must be according to the following three provisions unless the context requires a different meaning:

1. In interpreting the provisions of the Codes, any reasonable interpretation consistent with the objectives of the B-BBEE Act (Act) and an organisation's B-BBEE Strategy must take precedence.
2. Words importing persons shall, where the context requires or admits, include individuals, firms, partnerships, trusts, corporations, governmental bodies, authorities, agencies, unincorporated bodies of persons or associations and any organisation having legal capacity.
3. The Schedules and Annexes are a point of reference to the Codes.

The definitions featuring in Schedule 1 apply to the Exclusion Principle, which is an allowance in the Ownership Scorecard:

"Equity Instrument"	means the instrument by which a Participant holds Rights of Ownership in an Entity.
"Exercisable Voting Right"	means a voting right of a Participant that is not subject to any limit.
"Mandated Investments"	means any investments made by or through any third party regulated by legislation on behalf of the actual owner of the funds, pursuant to a mandate given by the owner to a third party, which mandate is governed by that legislation. Some examples of domestic mandated investments and the portions of those investments subject to the exclusion principle are contained in Annexe 100A attached to statement 100.
"Current Equity Interest Date"	means the later occurring of the date of commencement of statement 100 and the date upon which the transaction undertaken by the Measured Entity in order to achieve 'Black' rights of ownership became effective and unconditional.
"Participant"	means a natural person holding rights of ownership in a Measured Entity.
"Private Equity Fund"	means a third-party fund through which investments are made on behalf of the actual owner of the funds pursuant to a mandate given by that person to the private equity fund.
"Qualifying Transaction"	means a sale of a business, valuable business assets or shares, that result in the creation of sustainable business opportunities and transfer of specialised skills or productive capacity to 'Black' people.
All the definitions mentioned above filter through to "Rights of Ownership", which is the differentiating factor between a 'Form' and a 'Principle' according to the Ownership scorecard.	
"Rights of Ownership"	is a collective term for the right to Economic Interest and the right to Exercisable Voting Rights.

A 'Form' of Ownership links to Economic Interest and the effective Voting Rights applicable to a physical share. In short, it is about the control of an organisation. The Codes allow other avenues to achieve an organisation's objectives and targets. However, all Forms of Ownership incorporate equity, which means discarding the Voting Right and the Economic Interest associated with such disposal. Forms of Ownership may include but are not limited to:

> Direct and Indirect Equity Share Transactions between individuals and entities;
> Implementation of Trusts which house a type of scheme, namely an Employee Ownership Scheme or a Broad-Based Ownership Scheme;
> Trading and Family Trusts;
> The Sale of an Asset - further information appears on page 32;
> Private Equity;
> Equity Equivalents;
> Mandated Investments;
> Section 21 Companies or Companies Limited by Guarantee; and
> Options and Share Warrants.

A 'Principle' of Ownership is a concept that facilitates or promotes a 'Form' of ownership. The theory is the Principle links to commercial regulation complexities and how such commercial requirements impact a 'Form' of ownership. For example, Mandated Investments add to the complexity due to the mandates, owners and controlling parties associated with such investments. Consequently, determining the effective 'Black' Ownership percentage of an organisation with shareholding through this equity instrument is extremely difficult to calculate, due to the restrictions imposed on a Mandated Investment by Private Equity Fund Managers. Again, in terms of Private Equity Fund Managers and their commercial rights, determining the effective 'Black' Ownership is difficult or may not even be possible in terms of the B-BBEE legislative requirements. Hence, the B-BBEE framework made a provision to incorporate such complexities that would align with the objectives of the Act.

Introducing the Exclusion Principle: It is not associated with the physical disposal of a share, its Voting Right and Economic Interest, but rather a concept of recalculating an organisation's total 'Black' shareholding. The Codes allow an organisation to exclude portions of shareholding. However, applying the Exclusion Principle may impact the remaining forms of Ownership.

The Exclusion Principle automatically applies to organs of state and Public Entities, whereby these exclusions take preference over other avenues of Ownership. A Mandated Investment, for example, may not exceed 40% of the total exclusions derived in the Ownership score.

Before applying the Exclusion Principle, organisations must consider their fundamental requirements and the objectives. To determine the validity of a Mandated Investment and its subsequent inclusion or exclusion from the Ownership calculation, a B-BBEE Rating Agency must obtain recognition in a report form, compiled by a Competent Person. A B-BBEE Rating Agency will:

> Confirm all Mandated Investments held by an organisation;
> Inspect the share register for all Mandated Investments held by Collective Investment Schemes; for example, Pension Funds and Unit Trusts to name a few;
> Recalculate the Ownership taking the exclusion of Mandated Investments into account to ensure that it does not exceed 40%.

Applying the Exclusion Principle to Mandated Investments does not allow the application of the Modified Flow-Through Principle (MFTP). Applying the Exclusion Principle will impact the remainder of the Ownership Scorecard. The reason is that the Deemed Net Value calculation makes provision for a denominator which measures:

> The value of an organisation's measurable 'portion' on the date of an organisation's B-BBEE Verification in contrast to the 'value'. The result of the Deemed Value, taking the 'portion' and 'value' into account, has a direct impact on the Net Value calculation and the subsequent points awarded on the Ownership Scorecard. The following illustrates the calculation of the Exclusion Principle during a B-BBEE Verification.

Formula A: Net Value Calculation

$$A = B \times \left[\frac{1}{25\% \times C}\right] \times 8$$

B	is the Deemed Value for all 'Black' Participants in the Measured Entity determined using the Deemed Value Formula
C	is the Time-Based Graduation Factor of the Economic Interest compliance, the target of which is: > 10% for the first year after the current equity interest date. > 20% for the second year after the current equity interest date. > 40% from the first day of the third year after the current equity interest date to the last day of the fourth year after the current equity interest date. > 60% from the first day of the fifth year after the current equity interest date to the last day of the sixth year after the current equity interest date. > 80% from the first day of the seventh year after the current equity interest date to the last day of the eighth year after the current equity interest date. > 100% from the first day of the ninth year after the current equity interest date to the last day of the tenth year after the current equity interest date.

Formula B: Equity Instruments Calculation

$$A = \frac{B}{C} \times 8$$

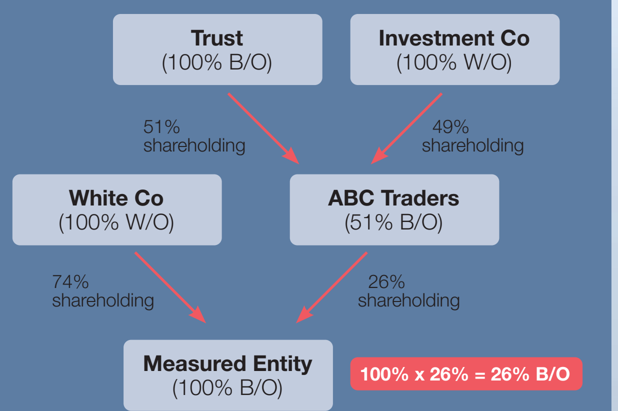
B	is the percentage Economic Interest in the Measured Entity of 'Black' Participants
C	is the target for the Ownership indicator in paragraph 2.3.1 of the Ownership scorecard.

Another common principle that relates to the Ownership Scorecard is the MFTP that applies to B-BBEE owned or controlled companies. Essentially, it seeks to promote transformation whilst allowing the participation of non-'Black' Participants at the first tier of ownership. The Codes unpack the principle, as:

> Where in the chain of Ownership 'Black' People have a flow-through level of participation of at least 51%, only then, once in the entire ownership structure of an organisation, may such 'Black' participation be treated as if it were 100% 'Black'-owned.

In the following illustration, ABC Traders has 51% 'Black' Ownership when applying the Flow-Through Principle (FTP). Using the same illustration but applying the MFTP, it deems an organisation to have 100% 'Black' Ownership. Therefore, applying the MFTP, the effective 'Black' shareholding is 26%, in contrast to 13,36% when applying FTP. What this means for the Measured Entity is that they would more than likely achieve total points for indicators 2.1.1 and 2.2.1 on the Ownership scorecard.

Modified Flow-Through Principle Example



Applying a single principle allowed on the Ownership calculation acts as a reward for transforming, thus showing an organisation's willingness to transform. The application of the Exclusion Principle generally occurs in Complex Ownership Structures. However, once another principle like the MFTP is applied, the option of the Exclusion Principle falls away. The rationale behind the principle is employed to promote a specific Form of Ownership. An organisation may not benefit from multiple principles allowed in the Ownership Scorecard, as doing that would result in misrepresentation of its ownership status.

Therefore, an organisation can have various Ownership vehicles; however, it may only apply one principle. Put another way, applying a principle effectively inflates an organisation's ownership score, in line with the expectations of the Codes.

In conclusion, the Ownership Scorecard is multi-faceted and complex. As the consequences for not accurately forecasting the outcome are so high, organisations must ensure that both the legal and B-BBEE boxes are ticked by those wholly versed in the B-BBEE space.

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