Transformation | Ownership

OWNERSHIP

TRANSACTIONS MUST WITHSTAND SCRUTINY

'Options and Share Warrants'

There are many vehicles organisations use to meet the Ownership Scorecard requirements; however, critical to an organisation's overall score is that an Ownership transaction must benefit the Beneficiary and not the vehicle driving the process. There are two givens when entering into an Ownership transaction for B-BBEE purposes. Firstly, it must make good business sense. Then it must withstand the scrutiny of a B-BBEE Verification and an investigation by the B-BBEE Commission, if necessary.

The Codes of Good Practice (Codes) in four paragraphs provide for 'Options and Share Warrants', a lesser-known Ownership vehicle. The structure affords future shareholding by allowing both an organisation and a buyer, in B-BBEE terms a 'Black' Participant, the opportunity to assess a partnership's feasibility and success before officially entering into a share transaction. Start-up Enterprises commonly use the 'Options and Share Warrants' avenue during their investor rounds or in the case of acquiring a Large Enterprise.

In this article, I will unpack the requirements for claiming Ownership Points under 'Options and Share Warrants', beginning with the applicable definitions from Schedule 1.

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Voting Rights	means voting right attaching to an Equity Instrument owned by or held for a participant measured using the Flow-through Principle or the Control Principle;
Exercisable Voting Rights	means a voting right of a Participant that is not subject to any limit;
Economic Interest	means a claim against an Entity representing a return on Ownership of the Entity similar in nature to a dividend right, measured using the Flow-Through and, where applicable, the Modified Flow-Through Principles;
Equity Instrument	means the instrument by which a Participant holds rights of Ownership in an entity;
Standard Valuation	means a standard valuation method for an asset, an Economic Interest, or any other instrument or right relevant to measurement under statement 100, undertaken using normal valuation methods that represent standard market practice;
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;
Acquisition debt	means the debts of: a) 'Black' Participants incurred in financing the purchase of an 'Equity Instrument' in the organisation; and b) Juristic persons or trusts in the chain of Ownership between the eventual 'Black' Participants and the organisation for the same purpose as those in (a);
51% 'Black'-owned	means an Entity in which: a) 'Black' People hold at least 51% of the 'Exercisable Voting Rights' as determined under Code series 100; b) 'Black' People hold at least 51% of the economic interest as determined under Code series 100; and c) Have earned all the points for 'Net Value' under statement 100;
Net Value	means the percentage resulting from the formula in Annexe 100(C) of statement 100, which links to the Deemed Value, which is:

Deemed Value is a crucial component of the 'Net Value' Transfer Calculation. Formula A and Formula B determine the difference between 'Net Value', and 'Economic Interest' calculate as follows:

Formula A

$$A = B \times (1/(25\% \times C)) \times 8$$

It incorporates the graduation factor, which evaluates the debt settlement over no more than ten years.

Where:

A = 'Net Value' in the hands of 'Black' Participants;

B = The Deemed Value for all 'Black' Participants in the Measured Entity (refer to Formula 3 in Statement 000);

C = The Time-based Graduation Factor of the Economic Interest compliance target.

Formula B

$$A = B/C \times 8$$

Determines the percentage of 'Economic Interest' of 'Black' Participants as a percentage of the Ownership target.

Where:

A = is the result of 'Net Value' Transfer Calculation;

B = is the percentage 'Economic Interest' in an organisation consisting of 'Black' Participants;

C = is the target for the Ownership indicator for 'Net Value' Transfer Calculation (currently at 25%).

To demonstrate how the Codes provide for 'Options and Share Warrants', the process will be illustrated through scenarios using:

ABC Traders, a Large Enterprise with a Status Level 3 and 110% Preferential Procurement Recognition. In 2017 it was valued using a 'Standard Valuation' method at R10m. In 2022, a re-evaluation using the same methodology set the value at R15m.

What are the rules that apply to 'Options and Share Warrants'?

The rules applicable for claiming points are under Statement 100, paragraph 3.13:

> The Ownership Scorecard recognises 'Exercisable Voting Rights' and 'Economic Interest' if a 'Black' Participant holds an 'Equity Instrument' or partly until a future date but within a specific time frame. However, it is on the provision that a 'Black' Participant has the first right to the agreed shareholding or a portion thereof at that future date, taking into account the agreed option period.

In 2017, ABC Traders identified a 'Black' Participant to acquire a 51% stake in the business with a five-year option period. All parties agreed that during, or at the end of the option period, the 'Black' Participant had the first right of acquisition to the said 51% stake. From the transaction date and throughout that period, the 'Black' Participant will hold 51% of the 'Exercisable Voting Rights' and gain 'Economic Interest' until the option period expires.

ABC Traders applies the 'Standard' Valuation' methodology using the Discounted Cash Flow (DCF) method to determine that a 100% stake in the business is R10m. ABC Traders secures the transaction through an agreement with the 'Black' Participant for a 51% stake in the business for R5.1m over five years.

Following the agreement, the 'Black' Participant is entitled to dividend payments and/or associated wealth once ABC Traders declares them. Furthermore, the 'Black' Participant has the right to vote at the same level as all shareholders.

Note

> 'Exercisable Voting Rights' are not 'Voting Rights'. The difference between the definitions is that 'Exercisable Voting Rights' refer to 'Voting Rights' that are not subject to any limit, meaning a 'Black' Participant has no restrictions or limitations when voting.
> The 'Voting Rights' associated with an 'Equity Instrument' must transfer to a 'Black' Participant for the duration of the option period.
> The 'Equity Instrument' must irrevocably transfer the value of 'Economic Interest' to a 'Black' Participant for the option period. They must receive the 'Economic Interest' linked to 'Economic Interest' due to them, like any other shareholder.
> 'Economic Interest' can be in the form of dividends or associated wealth for five years, even if the period extends over the share option period.
> The 'Equity Instrument' value must be determined using a 'Standard Valuation' method that calculates 'Net Value'.

Annually, on the date of measurement, a B-BBEE Rating Agency must ascertain whether an organisation met the objectives outlined in paragraph 3.13, statement 100 in the Codes:

"3.13.1 'Exercisable Voting Rights' and Economic Interest will be recognised where a Participant holds an instrument granting the holder the right to acquire an 'Equity Instrument' or part thereof at a future date, providing the following requirements are met:

3.13.2 The Exercisable Voting Rights attached to that instrument are irrevocably transferred to the holder for the option period and are exercisable by the holder before acquiring the Equity Instrument;

3.13.3 The value of 'Economic Interest' is irrevocably transferred for the option period and paid to the holder of that instrument before the exercise of that right;

3.13.4 The value of an instrument must be determined by using a 'Standard Valuation' method for calculating the 'Net Value'."

How is the value of an 'Equity Instrument' determined?

A vital part of any ownership transaction is the 'Equity Instrument' valuation before entering into a transaction. The 'Standard Valuation' methodology determines a fair market value that will establish the acquisition price. A valuation is necessary year-on-year from the transaction date, determining the outstanding 'Acquisition Debt' of the 'Black' Participant. The 'Equity Instruments' value determination must reflect whether it is more or less than the option price presented to the 'Black' Participant. The value of an 'Equity Instrument' must be re-established on a year-on-year basis. Therefore, the value of a transaction on the transaction date forms the basis for the transaction. However, although the share price increases, it is subject to the 'Net Value' calculation.

There are other methods for establishing the value of an 'Equity Instrument' on the transaction date. However, annual valuations determine the effective economic growth or value of the 'Equity Instrument' over the total option period. As the base cost pinpoints the transaction date, with annual reviews, the 'Black' Participant can track economic activity from the transaction date, year on year, to transparently reveal the 'Economic Interest' due to them.

What does it mean to exercise a share option?

At the end of five years, or at the point where the share option is exercised, a company re-evaluation will determine the value of the 'Equity Instrument' at that time, again applying the same 'Standard Valuation'.

The outcome of the year-on-year evaluation of ABC Traders revealed that in 2017 it was valued at R10m. Five years later, applying the same 'Standard Valuation' methodology, its value had increased to R15m, indicating a R5m increase over the five years.

Valuation over five years	Initial valuation March 2017 | R10m.	Revaluation March 2022 | R15m.
'Black' Participant's 51% stake in ABC Traders	R5.1m	R7.65m

Over five years, the value of the 51% stake in ABC Traders increased by R2.55m. However, the 'Black' Participant is entitled to and receives a return on ownership similar in nature to a dividend right based on the additional R2.55m based on the 2022 valuation.

Following the five-year share option, the 'Black' Participant has three choices:

Option 1	Option 2	Option 3
Take the R2.55 growth as entitled.	Carry the R2.55m against the 'Acquisition Debt'.	Opts to exit the share option, whereby the growth of ABC Traders would be payable

If an organisation experiences a decrease in value over the five years, the inverse will apply. Therefore, a drop in value is essential for 'Black' Participants to consider before entering such an agreement. There are various other ways to determine the value of a business. Yet, the share options' commercial requirements must align with the provisions of paragraph 3.13 of statement 100.

Importantly, the 'Equity Instrument', or vehicle an organisation uses to drive its ownership structures, must be relevant, thus stand the scrutiny of a B-BBEE Verification in line with the rules set out in statement 100.

How do Share options relate to different kinds of structures?

When using different types of legal entities or forms of Ownership as Option Holders, the relevant structures need to be verified according to the requirements and rules set out in Code Series 100.

When an Ownership structure includes a Trust, a non-profit organisation (NPO) and a Pty Ltd that further includes preference shares or options and share warrants, an organisation must ensure the relevant legal structures follow the guidelines laid out in the Codes.

Where a Trust is utilised as a vehicle for an NPO, an Employee Share Ownership Scheme (ESOP) or a Broad-Based Ownership Scheme (BBOS), a different set of rules applies in each case as per the definitions in Schedule 1 of statement 100, which are:

BBOS	ESOP	NPO
means an ownership scheme which meets the rules set out in Annexe 100B;	means a worker or employee scheme which meets the rules set out in Annexe 100C;	means a non-profit organisation registered under the Non-Profit Organisation Act of 1997;

In line with statement 100, ABC Traders sets up the following Ownership vehicles:

'Across-the-board' a BBOS	'Workforce' an ESOP	'Trustworthy' an NPO
> If a Trust takes the form of a BBOS, the measurement will be against the rules in Annexe 100B and its additional criteria. > If a Trust takes the form of an ESOP, the measurement must be against the rules in Annexe 100C and its additional criteria. Additionally, a trust must meet the rules as per Annexe 100D. > NPOs cannot issue shares, therefore, have no shareholders. In such a case, an NPO is measured according to the rules and the additional criteria applicable to an ESOP or BBOS. The relevant rules are determined by establishing the mandate of the NPO.		Step 1 'Trustworthy' meets the definition of 51% 'Black'-owned. Step 2 'Trustworthy' abides by the rules governing Trusts and achieves the additional applicable criteria as per Annexe 100(D).

In the instance where the vehicle takes the form of a Pty Limited, both the 'Exercisable Voting Rights' and the 'Economic Interest' percentages must accurately reflect and ensure that the definition '51% 'Black'-owned' is achieved. It is not a given that the percentage 'Exercisable Voting Rights' will equal the percentage of 'Economic Interest'. Therefore, ensuring both criteria meet the percentage requirement is essential. Overlooking this vital ingredient at the time of a B-BBEE Verification will impact the overall Ownership calculation.

Organisations entering into Ownership transactions for B-BBEE purposes must do due diligence and get not only a legal opinion, but one from a B-BBEE Professional. All parties must ensure that the transaction aligns with the B-BBEE Act and Codes of Good Practice.

What are the risks attached to facilitating an Ownership transaction?

All parties involved in an Ownership transaction for B-BBEE purposes must familiarise themselves with section 13O(2) and section 12N(3) of the B-BBEE Act. They set out the offence and penalty relating to 'Knowing People'. 'Knowing People' are at risk of imprisonment for up to 12 months. The term means that such a person knowingly turned a blind eye or should have known that a claim or initiative did not align with the Code they are measured on or The B-BBEE Act, which has outlined a 'Knowing Person' as follows:

a had actual knowledge of that matter; or
b was in a position in which the person reasonably ought to have –
  i had actual knowledge;
  ii investigated the matter to the extent that would have provided the person with practical knowledge; or
  iii taken other measures which, if taken, would reasonably be expected to have equipped the person with actual knowledge of the matter.

Who is a 'Knowing Person' as outlined in The B-BBEE Act?

To reiterate, a 'Knowing Person' is anyone who knows or should have known about Fronting Practices, an offence in the B-BBEE Act. A 'Knowing Person' would be at risk of prosecution if they:

> Hinder, obstruct or attempt to influence the B-BBEE Commission in performing its duties;
> Provide false information to the B-BBEE Commission;
> Misrepresent or attempt to distort the B-BBEE status of an organisation;
> Provide false or misrepresented information during a B-BBEE Audit;
> Are involved in and consented to the implementation of strategies or initiatives that are a Fronting Practice; and
> Failed to report awareness of suspected offences to the B-BBEE Commission, in the case of a Verification Professional or other individual.

Who is a 'Knowing Person'?

A 'Knowing Person' is any person who feeds into an organisation's B-BBEE Strategy at any level. Moreover, a Board of Directors is responsible for the management of an organisation. Their role is to lead an organisation in making strategic and operational decisions; subsequently, they are liable to ensure that an organisation meets its statutory obligations, knowingly or unknowingly, and are 'Knowing People'. The rationale behind this is the expectation that Directors have sufficient knowledge of The B-BBEE Act and Codes applicable to their organisations to identify and halt the implementation of Fronting Practices by employees or consultants.

Often organisations are advised against implementing an initiative suspected of being a Fronting Practice by their B-BBEE Consultant, Advisor or B-BBEE Rating Agency, but ignore such advice. It is important to note that any person operating in the B-BBEE space is legally obligated to report Fronting Practices to the B-BBEE Commission. Should a B-BBEE Consultant, Advisor or B-BBEE Rating Agency not report Fronting Practices, they would be guilty of an offence.

The accountability of a 'Knowing Person' remains intact, irrespective of whether a Director or Employee who is a 'Knowing Person' breaks ties with the organisation in question.

Many Directors, employees and 'Black' Participants who feed an organisation's B-BBEE Strategy are oblivious of the liability or the penalties attached to Fronting Practices. The most common reason is an over-reliance on consultants to drive an organisation's B-BBEE Strategy without internal competence. Organisations have, in the past, generally opted to lean on the knowledge and ethics of third parties.

Taking poor advice from a third party is not a defence against Fronting Practice. When it comes down to it, it will not only be the third party who will be penalised; it will be those directly involved and all other 'Knowing Persons' acting on behalf of an organisation. To mitigate the risk of taking third-party advice, an organisation should have at least one 'Knowing Person' within the organisation who is competent in identifying Fronting Practice risks and adequately questions or investigates them.

Organisations must ensure that 'Knowing People' feeding their B-BBEE Strategy are fully versed in not only The B-BBEE Act, but The Codes or the relevant Sector Code on which they are measured, along with all related practice notes and statements of clarity.