FACULTY OF LAW

A CRITICAL ANALYSIS OF THE FINANCIAL REGULATION OF PRIVATE EQUITY INVESTMENTS IN SOUTH AFRICA

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KEY WORDS

The following key words, expressions and terms are used in this mini-thesis:

Bewind Trusts

En commandite Partnerships

Financial Regulation

Initial Public Offering

Legal and Regulatory Framework

Private Equity

South Africa

LIST OF ACRONYMS

B-BBEE	Broad-based Black Economic Empowerment
BVCA	British Venture Capital Association
CGT	Capital Gains Tax
MOI	Memorandum of Incorporation
JSE	Johannesburg Stock Exchanges
FAIS	Financial Advisory and Intermediary Services Act
FMA	Financial Markets Act
GDP	Gross Domestic Product
GP	General Partners
IOSCO	International Organization for the Securities Commission

IPO	Initial Public Offering
JSE	Johannesburg Stock Exchange
LP	Limited Partners
PEI	Private Equity Investment
PFA	Pension Fund Act
SA	South Africa
ITA	Income Tax Act 1962
UK	United Kingdom
USA	United States of America
VC	Venture Capital

DECLARATION

I, Annah Kudanga, declare that **A Critical Analysis of the Financial Regulation of Private Equity Investments in South Africa** is my own work and that it has not been submitted before for any degree or examination in any other university, and that all sources I have used or quoted have been indicated and acknowledged as complete references.

Signed

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Annah Kudanga

June 2015

Signed _____

Professor M.S. Wandrag

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DEDICATION

I affectionately dedicate this work to my twin boys Brandon and Bradley

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ABSTRACT

Private equity is a critical vehicle of entrepreneurship development that is essential in reducing unemployment and boosting the economic growth of South Africa. There has, however, been a decline in private equity investment (PEI) activity in South Africa compared to the 2006-2007 peak and seed capital by venture capitalists has been affected the most. This has been attributed to a number of factors mainly related to financial and tax regulation. This study critically reviews the financial regulation of the PEIs in South Africa with a view to elucidating potential pitfalls that may be affecting the competitiveness of the industry. A comparison with the regulation of PEIs in the United Kingdom (which is generally regarded as functioning well) is also made in order to provide a basis for recommendations to improve private equity activity in South Africa. The main legal structures for PEIs in South Africa are the *en commandite* partnerships and the *bewind* trusts, of which *en commandite* partnerships are the most common legal structure. The private equity industry is mainly regulated by common law. However, there are various, separate sections of legislation that regulate private equity transactions as well as public companies. These fragmented pieces of legislation and regulations include the Financial Advisory and Intermediary Services Act, the Broad-based Black Economic Empowerment Act and the Black Economic Empowerment policy framework, the Companies Act, the Pension Funds Act, the Financial Markets Act, the Exchange Control Regulations 1961, the Competition Act, the Johannesburg Stock Exchange Listing Requirements and the King Reports on Corporate Governance. Of these, the most influential is the Financial Advisory and Intermediary Services Act which regulates financial service providers or fund managers. A comparison with the PEIs regulatory framework in the UK showed that the UK, apart from having a consolidated legislation regulating the legal structure of PEIs, generally, has a more comprehensive scope of regulation that includes self-regulation, co-regulation, and regional regulations, in addition to the traditional, conservative common law. This integration of regional requirements through EU's Directive 2011/61/EU and the Walker Guidelines has probably helped the UK to open up new markets in the region. Although there are some positives in the regulation of PEIs in South Africa, notably the regulation of financial markets to prevent market abuse and insider trading, it appears financial regulation may benefit from drawing lessons from the law and regulatory framework of the UK. It is therefore recommended that the South African private equity industry develops a consolidated and facilitative regulatory framework. This can be based on co-regulation along the lines of the Walker Guidelines (which encourages more disclosure and transparency) as well as a consolidated Act to control all PEIs activities.

CHAPTER 1

INTRODUCTION

1 BACKGROUND

Private Equity Investments (PEIs) are financial intermediaries that contribute immensely to the Gross Domestic Product (GDP)[1] and the economic growth of South Africa (SA) through the 'provision of equity capital to companies that are generally not listed on a public stock exchange.'[2] Over the years, the interest in the private equity market has increased because of the fact that PEIs experienced constantly higher returns than other more conventional forms of investments.[3] The private equity industry in SA does not have a single regulator or private equity legislation that 'exercises regulatory oversight over its funds.'[4] However, there are various, separate pieces of legislation and regulations that monitor private equity transactions as well as public companies. Since the inception of PEIs in the late 1980s in SA financial regulations that govern the industry[5] have evolved, and various other provisions have been introduced or amended that have impacted the performance of the industry.

The most important legislation influencing the private equity industry is the Constitution of the Republic of South Africa 1996 (the Constitution). The democratic value system sought by the Constitution is entrenched in the Bill of Rights (BOR) that embodies the legal values of dignity, equality and freedom as fundamental rights of every South African.[6] The Constitution advocates

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1 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

2 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

3 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

4 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

5 Johnson DA *Private Equity in Africa: An Evolving Market* (2013) 5.

6 the Constitution.

for core democratic values that influence every facet of PEIs such as basic human rights,[7] essential labour and employment rights,[8] as well as environmental rights, [9] making SA one of the few countries globally to have environmental rights in its constitution. It also provides for affirmative action as the right to equality and equal access to opportunities.[10]

The democratic SA that emerged after 1994 sought to resolve economic disparities through the introduction of new legislation such as the Black Economic Empowerment[11] (BEE) that was enacted in 2003[12] and was strategically modified in 2007 to become the Broad-based Black Economic Empowerment Act [13](B-BBEE Act). The shift by SA from the shareholder to the stakeholder model of corporate governance propelled legislation which provides for community development,[14] improved employee housing, affirmative procurement and ownership of shares by the previously disadvantaged black people.[15] The South African PEIs now had to take cognisance and adhere to the B-BBEE statutory policy framework that was aimed at enabling more 'economic participation by Black, historically disadvantaged individuals through the attainment of equity ownership or management of an investee company or both.'[16] Currently the 'funds under management in PEIs that can be categorised as non-empowered or unrelated to the B-BBEE Act account for 25.2 percent of the industry's total equity.'[17]

Corporate governance in the PEIs has not only been influenced by the provisions introduced by the Companies Act[18] but also the King Reports. The King II Report made recommendations that were in accordance with legislation, such as, 'the Employment Equity Act,[19] the Skills

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7 Sections 7-39 the Constitution.
8 Section 18 and 23 the Constitution.
9 Section 24 the Constitution.
10 Sections 8 (2) and (3) the Constitution.
11 Act 53 of 2003.
12 Act 53 of 2003.
13 Act 53 of 2003.
14 Act 71 of 2008.
15 Hamann R 'Corporate social responsibility, partnerships, and institutional change: The case of mining companies in South Africa' (2004) 28 *National Resources Forum* 280.
12 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).
17 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries- publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).
18 Act 71 of 2008.
19 Act 55 of 1998.

Development Act[20] and the BEE Commission Report in SA.'[21] This legislation is recognised in the King II Report as legislation that observes the concepts of good corporate governance. The King III Report mainly recommends that companies report on how they ensure corporate longevity or adherence to the triple bottom line requirements which are social, environmental and financial requirements.[22] Private equity transactions take cognisance of the King Code of Governance Principles particularly in portfolio companies and when they exit from investments through an Initial Public Offering (IPO) as it is a (Johannesburg Stock Exchange) JSE Listing requirement.

In addition, another change in regulations that has contributed immensely to the performance of PEIs in SA is the amendment in the laws and regulations of the Pension Funds Act[23] (PFA) of 2011. In accordance with the amended Regulation 28 of the South African PFA, 'pension funds can now invest up to 10 % of their assets in private equity funds and up to 15% of their assets in hedge funds and private equity funds combined.[24] The changes and clarification made in Regulation 28 of the PFA allow pension funds to invest more in PEIs and therefore drive the activities of the private equity industry with the increased capital inflow.[25] The investment periods of PEIs are well-matched with the long-term investment horizons of pension funds making it favourable for the industry.[26] In Europe, it has also been observed that the main benefitting 'institutional investors from the returns made by PEIs and Venture Capital (VC) firms have been pension funds, which in the year 2006 was the industry's biggest source of funds.'[27]

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20 Act 97 of 1998.

21 Mongalo T 'The emergence of corporate governance as a fundamental research topic in South Africa' (2003) 120 *SALJ*190 190.

22 Harvie MA *Analysis of The New Proposed Companies Act Compared To The Old Companies Act 61 of 1973 And The King 11 Report on Corporate Governance With Specific Focus On Directors Liabilities And Responsibilities* (unpublished MBA thesis, University of Stellenbosch, 2009) 21.

23 Act 19 of 2011.

24 Regulation 28 Pension Funds Act 24 of 1956.

25 Missankov I, Van Dyk R & Van Biljon M e*t al.* 'Is private equity a suitable investment for South African pension funds?' available at *http://www.itinews.co.za/content/media/companydocs/5f9cc53b-ddf5-4041-8151-2ced3b412681.pdf* (accessed 08 November 2013).

26 Missankov I, Van Dyk R & Van Biljon M e*t al.* 'Is private equity a suitable investment for South African pension funds?' available at *http://www.itinews.co.za/content/media/companydocs/5f9cc53b-ddf5-4041-8151-2ced3b412681.pdf* (accessed 08 November 2013).

27 Sahu R, Nath A & Banerjee P 'Trends in Private Equity and Venture Capital Investments with Special Focus on the Booming India Growth Story' (2009) 4 *Journal of International Commercial Law and Technology* 2 129.

Since the financial crisis there has been introduction of more laws and regulations that have impacted on the activities of SA's financial institutions and the manner in which they conduct business. However, the main regulators responsible for administering applicable legislation on private and public sector investments in SA, namely, the Financial Services Board (FSB) has not extended this regulation to PEIs. Currently, provided members of the public do not invest in PEIs, the FSB does not regulate the structures in which private equity funds are established. In its draft on the Specific Code of Conduct of Financial Services Providers and Representatives Conducting Financial Services Business with Professional Clients, the FSB explains that PEIs do not require the same amount of regulation, such as, that provided for in the Financial Advisory and Intermediary Services Act[28] (FAIS).

The financial crisis of 2008-2009 was mainly a result of the poor monetary system in the United States of America (US), the issuance of sub-prime loans that led to the housing bubble and inadequate or lax regulation of the financial markets by the government.[29] The South African financial market weathered the crisis successfully in comparison to the United States, European and Asian markets as a result of its concrete financial policies and limited use of complex, derivative financial products.[30] In addition, 'SA's banks had minimum equity capital requirements before the financial crises that were already at 15% which was almost double the international Basel III best practice recommendation of 8%.'[31] SA still remains the biggest and most established economy in sub-Saharan Africa with comparatively 'liquid financial markets that are well-regulated, sophisticated and sustained by a progressive common law-based legal system.'[32] According to the 2011/2012 World Economic Forum's Global Competitiveness Report, SA's securities exchanges are ranked amongst the top financial markets in the world.[33] Although PEIs aim to provide funds to unlisted private entities, the stability of financial markets

28 Act 37 of 2002.

29 Head JW 'The global financial crisis of 2008-2009 in context- reflections on international legal and institutional failings, fixes and fundamentals' (2011) 23 *Pac McGeorge Global Bus & Dev LJ* 53.

30 Financial Regulatory Reform Steering Committee (FRRSC) *Implementing A Twin Peaks Model of Financial Regulation In South Africa* (2013) 15.

31 Davis K 'Regulatory reform post the global financial crisis: an overview' available at *http://www.apec.org.au/docs/11_CON_GFC/Regulatory%20Reform%20Post%20GFC-%20Overview%20Paper.pdf* (accessed 28 February 2014).

32 Loggerenberg C 'South Africa's developing financial markets regulation' available at *http://www.iflr.com/Article/3093933/South-Africas-developing-financial-markets-regulation-analysed.html* (accessed 5 November 2014).

33 Salai-I-Martin X 'The global competitiveness report 2011-2012' available at *http://www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf* (accessed 6 November 2014).

influences the industry as an alternative investment destination, in building a positive reputation for SA amongst other emerging markets, when conducting buyouts and as an exit platform for IPOs. Therefore another change that has influenced PEI activities is the introduction of the Financial Markets Act[34] (FMA) which replaces the Securities Services Act.[35] The FMA has become the main legislation to govern the activities of financial markets, securities services and infrastructure of markets in SA.

PEIs are very important to the economy of SA and can potentially contribute more to the prosperity of the country through employment creation and economic growth.[36] A number of scholars argue that the existence of an active private equity and Venture Capital (VC) market in an economy allows the efficient allocation of capital and that PEI funds go directly to entities where they are most effectively and efficiently used which results in optimal compensation 'per given level of risk.'[37] The South African Venture Capital Association (SAVCA) outlines the importance of private equity as that;

> *"Private equity can be used to develop new products and technologies, to expand working capital, to make new acquisitions or to strengthen a company's balance sheet. It can also be used to resolve ownership and management issues, succession in a family-owned business or the buyout or buy-in of a business by experienced managers.*"[38]

In SA, the social influence of PEIs is essentially related with the B-BBEE through investor participation in transactions that promote the B-BBEE.[39] The PEIs are linked with high

34 Act 19 of 2012.
35 Act 36 of 2004.
36 Sahu R, Nath A & Banerjee P 'Trends in private equity and venture capital investments with special focus on the booming India growth story' (2009) 4 *Journal of International Commercial Law and Technology* 2 129.
37 Portmann D & Mlambo C 'Private equity and venture capital in South Africa: a comparison of project financing decisions' (2013) 16 *SAJEMS* 3.
38 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).
77 Missankov I, Van Dyk R & Van Biljon M e*t al.* 'Is private equity a suitable investment for South African pension funds?' available at *http://www.itinews.co.za/content/media/companydocs/5f9cc53b-ddf5-4041-8151-2ced3b412681.pdf* (accessed 08 November 2014).

investment returns and diversification benefits that present an opportunity to meet the B-BBEE objectives.[40]

Respondents in a 'survey carried out in 2009 by Herrington and Kew and Kew, showed that 81% of the participants singled out the lack of capital' as the biggest challenge in their firms.[41] To this end, private equity is an essential source of financing for portfolio companies and also contributes 'expertise, networks, alliances and new customers to the firms it funds.'[42] Private equity's seed capital targets firms in the introductory phase with high-growth potential concepts, products and services. This may be crucial for industries that need to quickly attain and sustain a competitive advantage, such as, telecommunications, software, bio-technology and internet services.[43] Another essential feature of private equity is that it provides capital to high-risk firms which other lenders would not fund, such as; rapidly growing firms without track records, entities that constantly require external financing and companies with financial difficulties.[44]

When private equity funds invest in a company, they retain some control, and can influence the composition of management in investee companies. The appointment of the board of directors after investing in portfolio companies allows the PEIs to actively implement and monitor the strategic and operational plans of the portfolio company. As a result, PEIs have access to the companies' assets and income sources, which can allow them to make very high profits.[45] In addition, PEI equity can improve a company's stock price when potential investors speculate that a buyout is expected to take place.[46] Private equity investors' rank alongside banks, shareholders,

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40 Missankov I, Van Dyk R & Van Biljon M e*t al.* 'Is private equity a suitable investment for South African pension funds?' available at *http://www.itinews.co.za/content/media/companydocs/5f9cc53b-ddf5-4041-8151-2ced3b412681.pdf* (accessed 08 November 2014).

41 Portmann D & Mlambo C 'Private equity and venture capital in South Africa: a comparison of project financing decisions' (2013) 16 *SAJEMS* 3.

42 Portmann D & Mlambo C 'Private equity and venture capital in South Africa: a comparison of project financing decisions' (2013) 16 *SAJEMS* 3.

43 Sahu R, Nath A & Banerjee P 'Trends in private equity and venture capital investments with special focus on the booming India growth story' (2009) 4 *Journal of International Commercial Law and Technology* 2 128.

44 Portmann D & Mlambo C 'Private equity and venture capital in South Africa: a comparison of project financing decisions' (2013) 16 *SAJEMS* 3.

45 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

46 Loubser J & Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

and other lenders but they do not require interest payments on their capital.[47] For this reason, PEIs are particularly focused on ensuring that the firm overcomes its difficulties or makes profit as they stand to lose all of their investment if the deals fail. Private equity is also very important as it is a source of Foreign Direct Investment (FDI) in SA, through the raising of offshore funds by PEI's as well as co-investments with foreign investors.[48] However, the full potential of PEIs can only be fully realised if there is a supportive regulatory framework.

1.2 STATEMENT OF THE PROBLEM

Current funds under PEIs management in SA have had an average compound annual growth of 11.8% since 1999.[49] Despite the general achievement and popularity in PEIs, there appears to be a number of emerging issues or problems militating against the continuing, high growth in the sector. In the past six years investments in private equity have declined from the record level and historical peak of R15.4 billion in 2007 to R10.7 billion in 2011.[50] Private equity's raising of funds and the success rate thereof has not returned to the 2006–2007 levels and new investments' average deal size in the PEIs sector went down from 'R21.2million in 2011 to R19.2 million, in 2012 while follow-on investments average deal size decreased from R50.6 million, during 2011 to R26.2 million during 2012.'[51] In addition, the average investment deal size decreased from R30.7 million for the year 2011 to R21.9 million in the year 2012.[52] On the contrary, the UK, which is one of the worlds' most established private equity markets had a high fundraising for

47 KPMG Africa 'The promise and obstacles facing private equity investment in Africa' available at *http://www.blog.kpmgafrica.com/the-promise-and-obstacles-facing-private-equity-investment-in-africa/* (accessed 05 November 2014).

48 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calender year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 05 November 2014).

49 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calender year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

50 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

51 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

52 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

the same period.[53] Since taxes and similar financial regulatory measures generally add a significant cost of doing business, most investors regard them as a regulatory constraint that is unfavourable for investments.[54] Although tax regulation is an important factor in the performance of PEIs, the area of tax regulation is outside the scope of this mini-thesis. This mini-thesis seeks to critically analyse the financial regulation of PEIs and benchmark it against that of the UK as a way of determining ways of improving financial regulation and possibly the performance of the PEIs in SA. The mini-thesis seeks to answer the following questions:

- What is the current structure of the financial regulation of private equity investments in SA?
- What is the current structure of the UK financial regulation of private equity investments?
- Based on the comparative analysis with the UK, what recommendations can be made with regards to the financial regulation of private equity investments in SA?

1.3 RESEARCH QUESTION

What recommendations can be made regarding the financial regulation of the PEIs in SA, to ensure its continued growth, using the UK financial regulatory framework as a benchmark?

1.4 PRINCIPAL AIM AND OBJECTIVES OF THE STUDY

The main objective of this study is to analyse the legal and regulatory framework of PEIs in SA with the focus on financial regulation. This was done by looking at regulatory changes that have affected PEIs, and also by comparison of the private equity-regulatory activity in SA against a benchmark economy of the UK that is known for its attractive financial and tax regime.[55] Given

53 Private Equity International Research and Analytics *Quarterly Review* (2013).

54 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

55 Delloitte 'South Africa - at risk of losing private equity investment to other emerging markets' available at *http://www.deloitte.com/view/en_za/za/a02ec5275d0fb110VgnVCM100000ba42f00aRCRD.htm* (accessed 27 November 2014).

the comparative value of the UK as one of the most developed private equity markets,[56] this study discusses the legal and regulatory framework of private equity in the UK and compares it with that of SA in areas such as investors' rights, company law, stock markets and affirmative action. Such a comparative analysis was done in order to single out the areas of focus in the legal and regulatory framework in financial regulation that impact private equity activity in SA.

Although the industry contributes to economic growth in SA, the slow growth of PEIs and VC investments is a major cause for concern.[57] Unfortunately, research on financial regulation of PEIs particularly in the South African context is noticeably limited.[58] The purpose of this study is to understand the financial regulations that govern these essential private equity funds and compare them with the UK financial regulatory framework, particularly in the time period when the industry has had a decline in its activity. It is envisaged that recommendations from this current research may help in stimulating high growth in PEIs in SA.

1.5 SIGNIFICANCE OF THE STUDY

The significance of this study is that if the financial regulations are to effectively regulate the private equity, it is imperative that there is a deeper understanding of the application and implication of the laws on economic activities in this sector. Empirical results from studies carried out on the USA time series data have also shown that VC is hugely affected by 'legislation and the regulation of pension funds, levels of Capital Gains Tax (CGT) and the provision of subsidies.'[59] An appreciation of the financial regulation on PEIs and their growth will go a long way in influencing governmental policies in this particular area, especially, by highlighting particular areas impacting negatively on the growth of PEIs, which by extension adds to a host of other economic challenges such as the increase in the rate of unemployment. Although research has been performed on the impact of financial regulation on private equity funds in an international context, this study focuses on the financial regulation of PEIs in SA and

56 Private Equity International Research and Analytics *Quarterly Review - Q3* (2013).
57 Portmann D & Mlambo C 'Private equity and venture capital in South Africa: a comparison of project financing decisions' (2013) 16 *SAJEMS* 3.
58 Portmann D & Mlambo C 'Private equity and venture capital in South Africa: a comparison of project financing decisions' (2013) 16 *SAJEMS* 3.
59 Armour J & Cumming D 'The legislative road to Silicon valley' (2006) 58 *Oxford Economic Papers* 599.

seeks to compare the financial regulation in SA with that of the UK as a way of determining ways of improving financial regulation and possibly the performance of the PEIs in SA.

1.6 METHODOLOGY

A qualitative research methodology was used for this mini-thesis. An analytical and prescriptive approach was applied. Reference was made to primary sources which form the South African legislation that is applicable to PEIs. The mini-thesis entailed a review of secondary sources of information relevant to the matter namely South African and international textbooks, journal articles and academic writings on the topic studied as well as on related issues. Scholarly articles and materials from the library and the internet were also examined. A comparative analysis was made with an off-shore jurisdiction namely, the UK, which is generally considered an attractive private equity destination.[60] In order to achieve the objectives outlined in section 1.4 above, the mini-thesis applied techniques of comparative research methodology that help to establish similarities and differences between the systems compared. In this regard, primary attention was devoted to comparing and analysing the laws, the policies, and the administrative measures taken in the implementation of financial regulation in the countries examined.

1.7 LIMITATION OF SCOPE

Owing to the limits on the length of an MPhil mini-thesis, this study is constrained to restrict the comparative analysis and discussion of the research problem to a critical examination and test of one jurisdiction namely the UK. The UK was used for the reason that the UK is a renowned, developed[61] and attractive[62] private equity destination. Although this critical analysis of financial regulations on PEIs in SA will review off-shore private equity funds and take cognisance of the impact of tax regulations on PEIs it will not concentrate on tax laws in South Africa or the international tax agreements between SA and other countries as these are outside the scope of this mini-thesis.

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60 Verfides 'UK private equity funds: tax-efficient structuring' available at *http://www.verfides.net/images/uploads/PrivateEquity.pdf* (accessed 22 April 2014).

61 Private Equity International Research and Analytics *Quarterly Review - Q3* (2013).

62 Verfides 'UK private equity funds: tax-efficient structuring' available at *http://www.verfides.net/images/uploads/PrivateEquity.pdf* (accessed 22 April 2014).

1.8 OVERVIEW OF CHAPTERS

This mini-thesis is organised into six chapters as outlined below:

Chapter two gives the general overview of private equity legal structures namely the *en commandite* partnerships and *bewind* trusts.

Chapter three provides a broad outline of financial regulation of private equity funds under the South African law. In the chapter the different pieces of legislation and regulations that affect private equity transactions are discussed.

Chapter four provides a critical analysis of SA's financial regulations in comparison with another competitive jurisdiction namely, the UK. The main reason is to establish the United Kingdom's legal and regulatory framework on private equity and its effectiveness compared with SA. Given the historical relationship between the UK and SA, a number of similarities in the legal systems regulating private equity exist and are also discussed.

Chapter five discusses the implications of financial regulation on private equity investments in SA. The discussion provides a basis for recommendations suggested in Chapter six.

Chapter six concludes the mini-thesis and suggests recommendations for improving financial regulation of private equity funds in SA.

CHAPTER 2

THE LEGAL STRUCTURE OF PRIVATE EQUITY INVESTMENTS IN SOUTH AFRICA

2.1 INTRODUCTION

In economic terms private equity is defined as capital that is temporarily invested in new or growing firms that are not listed on the public stock exchange in return for part ownership and a share of the profits of the firms.[63] Private equity investors usually buy a stake in a private or public company for a few years. They aim to ultimately increase the value of the stake by improving the financial and operating results of the company and then exiting by selling back their shares to the business while making a profit on the investment.[64]

The major investment structures of private equity funds in SA are *en commandite* partnerships and *bewind* trusts. Alternatively, where the 'appropriate regulatory requirements permit, a collective investment scheme structure can sometimes be used to house private equity funds.'[65] PEIs may sometimes take the legal structure of a company. In SA, the corporate legal structure is not really preferred by investors as companies are viewed 'as not being tax transparent and can potentially increase the tax burden for investors.'[66] In addition, corporations pay taxes separately and apart from the owners which can potentially lead to double taxation: first, on profits made by the company and secondly on the dividends given to the shareholders. The *en commandite* partnership and *bewind* trust legal structures ensure that the liability for taxes is not on the fund itself but on the individual investors in the private equity fund.[67] These PEIs legal structures are

63 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

64 Marples D.J *Taxation of Hedge Fund and Private Equity Managers* (2014) 3.

65 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

66 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

67 Loubser J, Viviers J & Minnaar A 'The private equity review' available at

generally not subject to burdensome regulatory oversight and legislation plays a limited role in their regulation. Therefore, in sum, the legal structures common with PEIs in SA are the *en commandite* partnerships and *bewind* trusts.

It has been proposed that to some extent the legal structure of private equity funds influences the way they are regulated. Therefore, this chapter reviews the structure of PEIs in SA; specifically the major private equity legal structures, namely, the *en commandite* partnerships and *bewind* trusts, and the implications of these structures in the regulation of private equity funds.

2.2 PRIVATE EQUITY LEGAL STRUCTURES IN SA

2.2.1 *En commandite* partnerships

A partnership is a 'legal agreement between two or more persons, who undertake to contribute to a lawful enterprise which is carried on with the object of making a profit and sharing it between the partners.'[68] In SA, a partnership is not a legal person distinct from the partners that set it up.[69] A partnership in SA has no separate legal identity or existence and in general, it has no limited liability. South African partnership law is common law based. There are several important legal implications that arise because the partnership does not have a separate legal *persona* distinct from the members who form it. The legal nature of a partnership in SA is such that the 'rights and liabilities of the partnership are the rights and liabilities of the partners, and are enforceable by and against them individually.'[70]

Partnerships in SA can be broadly classified as general (ordinary) partnerships or extraordinary partnerships, depending on the liability of the partners and the extent of the profit-sharing. Extraordinary partnerships are either anonymous (sleeping) partnerships or e*n commandite* (limited) partnerships. PEIs often take the legal structure of *en commandite* partnerships. An *en commandite* partnership is a form of a partnership in which there are one or more silent partners who contribute funds and are only liable for the capital invested.[71] It has two categories of

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http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4 (accessed 8 November 2014).

68 Cassim FHI et al *The Law Of Business Structure* (2012) 13.

69 Cassim FHI et al *The Law Of Business Structure* (2012) 18.

70 *Strydom v Protea Eiendomsagente* 1979 (2) SA 206 (T).

71 Dudley Lee '*En commandite* partnerships' available at *http://www.ghostdigest.co.za/articles/en-commandite-*

partners, namely, the disclosed or general partner (GP) and the undisclosed or limited partner[72] (LP) (Fig. 1). The GPs, also referred to as the managing partners in the *en commandite* partnership, are the private equity firms, while the LPs are external investors. In return for their expertise and for managing the PEIs, the GPs charge advisory or management fees. The charge made by GPs that is linked to the performance of the PEIs is known as carried interest.[73] All the partners in private equity funds are bound by the requirement to carry on the PEIs' activities to the greatest common advantage.

South African law allows a natural person, a company and another partnership to invest in an *en commandite* partnership. Previously, the Companies Act[74] limited a private entity which had a goal of making profit to a maximum of 20 members, otherwise it would then be incorporated into a public or private company; but the new Act[75] does not have this prohibition. The statutory limit on the number of partners in registered partnerships formed in SA was abolished in 2010.[76] Generally, private equity funds are constituted by 10 to 30 LPs, who are mostly institutional investors.

partnerships/54506 (accessed 16 January 2015).

72 Section 24H of the Income Tax Act.

73 Marples DJ *Taxation of Hedge Fund and Private Equity Managers* (2014) 3.

74 Section 30 Companies Act 61 of 1973.

75 Act 71 of 2008.

76 Cassim FHI *The Practitioner's Guide to the Companies Act 71 of 2008* (2011) 5.

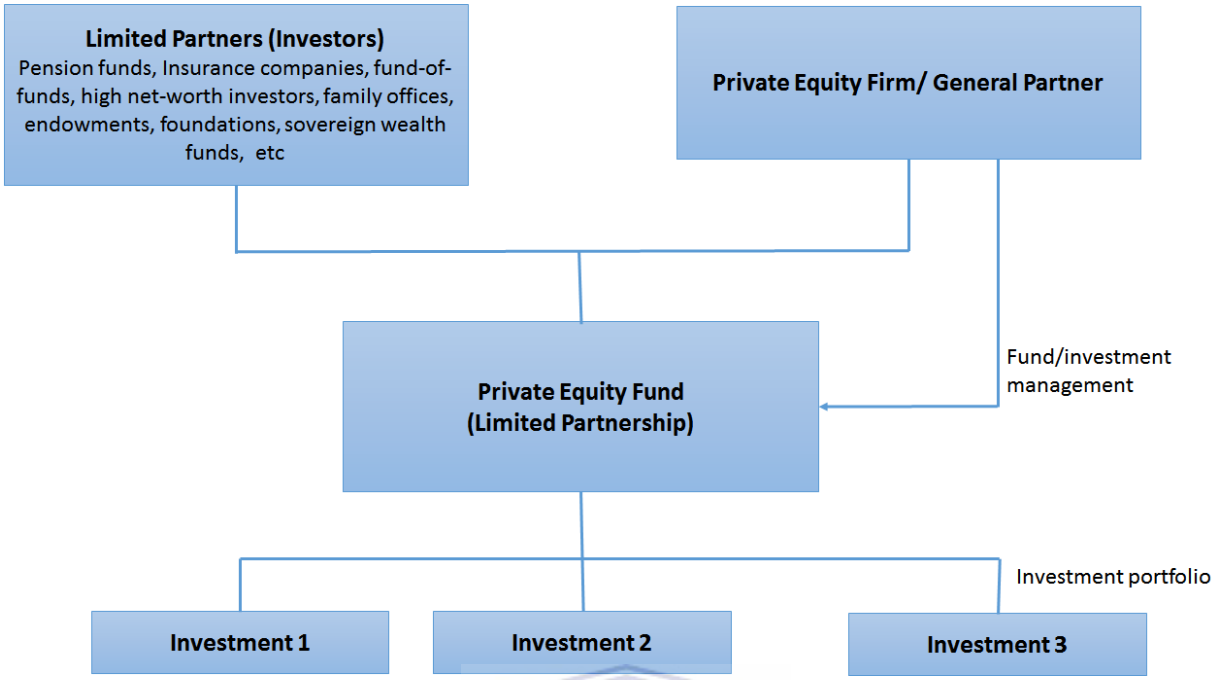

Figure 1: The legal structure of the *en commandite* partnership

Adapted from SAVCA (2010:6)[77]

The e*n commandite* partnership provides LPs, who are also called commanditarian partners or the partners whose names are not disclosed, with limited liability. Examples of LPs are insurance companies, banks, foundations, endowments, collective investment schemes, government agencies, private equity funds, development funding instuitions and individual investors with significant resources. By participating in an e*n commandite* partnership a LP is afforded special common law protection from creditors in case of insolvency and owes the partnership only to the extent of the amount contributed.[78] The LPs cannot actively participate in the management of the private equity fund established as an e*n commandite* partnership and may lose their common law limited liability protection if they do so. The LPs are only financial participants who invest a fixed amount of money, receive a certain share of the profits and have restricted liability similar

[77] Submission to National Treasury: An Industry Response to Regulation 28 Pension Funds Act 24 of 1956 16 April 2010.

[78] *Mmabatho Food Corporation (Pty) Ltd v Fourie* 1985 (1) SA 318 (T).

to that of members of a close corporation or shareholders of a company.[79] However, there are slight differences between the LPs in an *en commandite* partnership and the shareholders of a company. The differences include that shareholders have proprietary rights to any property left after winding up, and proprietary rights to transfer their shares as they can cede their shares to a third party if they no longer want to be a part of a company. Transfer of an interest in an *en commandite* partnership can only be made 'with the authorisation of a GP but only after strict due diligence, and in some funds only after a minimum initial investment period'.[80]

The GPs on the other hand have unlimited liability in an *en commandite* partnership and generally invest 1% of the total funds.[81] The GPs have the full decision making authority, full financial liability and can be sued for the full amount of the suit. This means that if the partnership is declared insolvent by a court, the GP and not the *en commandite* partners will be sequestrated. However, the 'current market practice in SA tends to exempt the GP from liability for all but gross negligence, criminal conduct and material breach of the partnership agreement'.[82] Therefore, market practice tends to 'indemnify the GP against all losses that are not caused by gross negligence or criminal conduct'.[83]

The *en commandite* partnerships are cheap to form and can be established with relative ease as they are established by contract[84] and, unlike a company; do not have to be incorporated through a Memorandum of Incorporation. A partnership agreement governs the issues of methodology and information requirements in an *en commandite* partnership. The contract between the LP and the GP expressly reflects the intention[85] of establishing an *en commandite* partnership and expressly identifies the general or disclosed partners. In addition, individual, institutional investors, such as pension funds, may negotiate side letter terms. The side-letter terms set out the

79 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

80 Joint Money Laundering Steering Group 'Private equity' available at *http://www.jmlsg.org.uk/download/8179* (accessed 28 December 2014).

81 Khoza F 'Retirement funds in private equity funds: some issues to consider' available at *http://www.bowman.co.za/News- Blog/Blog/retirement-funds-investment-private-equity-funds* (accessed 28 December 2014).

82 Khoza F 'Retirement funds in private equity funds: some issues to consider' available at *http://www.bowman.co.za/News-Blog/Blog/retirement-funds-investment-private-equity-funds* (accessed 28 December 2014).

83 Khoza F 'Retirement funds in private equity funds: some issues to consider' available at *http://www.bowman.co.za/News-Blog/Blog/retirement-funds-investment-private-equity-funds* (accessed 28 December 2014).

84 A contract is a binding agreement or promise to do something.

85 *Purdon v Muller* 1961 (2) SA 211 (A).

'conditions and set self-imposed restrictions between the GP and the LP in order to protect the investor's interests.'[86] Examples of some terms that LPs may include as investment restrictions may include the following:

> *'restrictions on geographic and sector exposure and on borrowing and hedging, key persons' time commitment, the appointment of an investors' advisory board, which usually regulates conflicts of interest that have been paid in excess of the GP's entitlement and reserved matters that require limited partner approval'*[87]

The covenants or restrictions in a side letter allow GPs and LPs to align their objectives and reduce agency costs. The side letter further clarifies the potential management objectives of the private equity fund and those of portfolio companies.

As stated above, the e*n commandite* partnership is not a juristic person or a corporate entity and cannot have an estate. The estates of the partners and the e*n commandite* partnership are mostly regarded as separate.[88] Therefore the assets of the partnership are held by the GPs and LPs 'as co-right holders and this common stock may be called the partnership estate.'[89] 'Co-owners of partnership property hold such property in undivided shares and the property may only be' used for partnership purposes.[90] In an *en commandite* partnership the partners own the assets in proportion to their contributions. On the other hand, a company is a legal person that exists,[91] and the shareholders do not own what the company owns. A company has the power to enter into a contract[92] in its own name, can sue and be sued. Similarly, a partnership may sue and be sued in its name as it is considered a separate entity on matters of civil procedure.[93] The concept that partnerships have no legal persona is not followed through particularly on matters of insolvency, litigation, value-added tax and some common law exceptions.

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86 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

87 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

88 Section 13 Insolvency Act 24 of 1936.

89 Stephan van der Merwe Attorneys 'The law of partnership -principles of the South African law of partnership' available at *https://sites.google.com/site/stephanvdmerwe/thelawofpartnership* (accessed 5 February 2014).

90 Stephan van der Merwe Attorneys 'The law of partnership - principles of the South African law of partnership' available at *https://sites.google.com/site/stephanvdmerwe/thelawofpartnership* (accessed 5 February 2014).

91 *Dadoo Ltd v Krugersdorp Municipal Council* 190 AD 530.

92 Section 33 Companies Act 71 of 2008.

93 High Court Rule 14 (5) (h).

The *en commandite* partnership is usually terminated as agreed by all the partners in the partnership agreements, which may, for example, provide that the GP may end the partnership after notifying the other partners.[94] In SA, a private equity fund is generally operated for 10 to 12 years and then it is wound up.[95] This is in contrast to a company that has a perpetual existence.[96] The South African legislation provides ways of liquidating or dissolving a company. On the other hand, in an *en commandite* partnership, 'when there is death, resignation, retirement, insolvency of partner and when a new partner enters the partnership, the old partnership is dissolved.'[97] In such an instance, on a technical basis, each of the partners disposes of a portion of the underlying investments to the new partners, which may cause potential tax implications on unrealised gains for the other partners.

PEIs structured as e*n commandite* partnerships cannot be bound outside the terms of the partnership agreement. While the provisions of the partnership agreement bind the GP and LP, they are not necessarily binding on the creditors of the partnership.[98] *En commandite* partnerships are governed by the South African common law and by specific sections of the Insolvency Act. The common law rules laid by the courts on partnerships are default principles that only apply when the partnership agreement does not modify them or is silent on the issue.[99] The common law in SA is based on the Roman and Roman-Dutch law and consequently the Roman-Dutch law governs *en commandite* partnerships. The Roman Dutch law in SA is found in the writings of a number of jurists that include Johannes Voet and Hugo de Groot. These writings are considered authoritative by the South African courts. The 'treatise on the law of partnerships by the French jurist Pothier, together with English cases that have heavily influenced the South African law' of partnerships also apply in the regulation of *en commandite* partnerships.[100] The regulatory framework of *en commandite* partnerships under South African and English law has a number of similarities; however, there are also some essential distinctions

94 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).
95 Marples DJ *Taxation of Hedge Fund and Private Equity Managers* (2014) 3.
96 Section 20 Companies Act 71 of 2008.
97 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).
98 Cassim FHI *The Practitioner's Guide to the Companies Act 71 of 2008* (2011) 25.
99 Cassim FHI *The Practitioner's Guide to the Companies Act 71 of 2008* (2011) 25.
100 Stephan van der Merwe Attorneys'The law of partnership -principles of the South African law of partnership' available at *https://sites.google.com/site/stephanvdmerwe/thelawofpartnership* (accessed 5 February 2014).

between the two, some of which will be discussed in Chapter 4. In such cases the English law only serves as a guide.[101]

2.2.2 B*ewind* trusts

The second investment structure in which PEIs in SA are typically structured is the *bewind* trust. A *bewind* trust is a legal structure in which the 'founder of the trust transfers assets or property to an intermediate person known as a trustee and gives them the right to hold and manage the assets or property for the benefit of beneficiaries.'[102] The main difference between a *bewind* trust and an ordinary trust and is that the ownership of the applicable property in the former is conferred on the beneficiaries of the trust and not the trustees.[103] In other types of trusts, the property of the trust is owned by the trustees on behalf of beneficiaries. The trustees hold the assets in line with the provisions of the trust deed and separate from their own estates.[104] In a *bewind* trust the beneficiaries own the assets but the control and management of the assets vests in the trustees.

The term '*bewind'* originated from the Dutch law (*bewind*) and the Roman-Dutch law (*bewindhebber*) concept of administration. Although the Roman and Roman-Dutch law forms the foundation of South African common law, the concept of trusts in the South African jurisprudence originated mostly from Germanic and English law.[105] In sum, the laws that now regulate and govern a *bewind* trust in SA are the common law, the Trust Property Control Act and the trust deed.[106] The Trust Property Control Act[107] mainly oversees specific administrative issues concerning trusts.[108]

Although there are a number of statutes in SA that define a trust as a legal person generally *a bewind* trust is not a legal person unless such a definition applies. An example, is the Income Tax

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101 Stephan van der Merwe Attorneys'The law of partnership -principles of the South African law of partnership' available at https://sites.google.com/site/stephanvdmerwe/thelawofpartnership (accessed 5 February 2014).

102 Smith BS *The Authorization of Trustees in the South African Law of Trusts And Responsibilities* (unpublished LLM thesis, University of the Free State Bloemfontein, 2006) 7.

103 Trust Property Control Act 57 of 1988.

104 Geach W & Yeats J *Trusts* (2007) 171.

105 Smith BS *The Authorization of Trustees in the South African Law of Trusts And Responsibilities* (unpublished LLM thesis, University of the Free State Bloemfontein, 2006) 9.

106 Trust Property Control Act 57 of 1988.

107 Trust Property Control Act 57 of 1988.

108 Geach W & Yeats J *Trusts* (2007) 171.

Act,[109] which defines a trust as a 'legal person' that can 'incur tax liability for the income that it earns during a year of assessment or on any capital gains on the disposal of capital assets.'[110] The other statutes, such as, the Close Corporations Act,[111] The Companies Act,[112] The Transfer Duty Act,[113] The National Credit Act,[114] and the Financial Intelligence Act[115] (FICA) also define a trust as a legal person.

When private equity vehicles are structured as *bewind* trusts, the initial assets of the trust are the amounts contributed by the institutional investors. The trustees of the *bewind* trust then appoint fund managers to make investments. The trustees in the PEIs do not own the undivided shares; the shares are owned by the investors of the trust.[116] Therefore the institutional investors are the beneficiaries of the *bewind* trust, who 'own the jointly undivided shares in proportion to their respective contributions.'[117]

The *bewind* trusts are established by way of a document that is called a trust deed.[118] The document gives physical confirmation of ownership in a piece of real property. The rights of the beneficiaries are derived from the trust deed and as a result they can enforce the founder's objectives.[119] The major requirement in the formation of *bewind* trusts is that the beneficiaries have to be clearly identified and there needs to be at least one beneficiary for the trust to be valid. The *bewind* trust deed sets out the rights, duties, obligations, parties and the constitution of the trust and the Trust Property Control Act[120] provides for the the significance of the duties. The Act only regulates certain administrative aspects that relate to *bewind* trusts.[121] In comparison to the Companies Act or the Close Corporations Act, The Trust Property Control Act does not

109 Income Tax Act 58 of 1962.
110 Section 1 Income Tax Act 58 of 1962.
111 Act 69 of 1984.
112 Act 71 of 2008.
113 Act 40 of 1949.
114 Act 34 of 2005.
115 Act 38 of 2001.
116 Loubser J, Viviers J & Minnaar A 'The private equity review' available at http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4 (accessed 8 November 2014).
117 Loubser J, Viviers J & Minnaar A 'The private equity review' available at http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4 (accessed 8 November 2014).
118 *Land and Agricultural Bank of South Africa v Parker* 2005 (2) SA 77 (SCA).
119 *RAS and Others NNO v Van der Meulen and Another* 2011 (4) SA 17 (SCA).
120 Act 57 of 1988.
121 Geach W & Yeats J *Trusts* (2007) 4.

regulate the establishment of a trust as strictly as the aforementioned Acts do with their respective entities.

Unlike a company that comes into existence through incorporation, *bewind* trusts are formed through a registration process that is approved by the Master of the High Court.[122] When setting up a *bewind* trust in SA 'the assets and property need to be defined with certainty and the object has to be made sufficiently certain.'[123] The Master has extensive regulatory powers in relation to the trust and may, for example, in certain instances remove the trustees or apply to court for their removal.[124] The trustees that are appointed to manage a *bewind* trust are required to be capable of carrying out their duties. When a trustee fails to execute any responsibilities that are enforced by a 'trust instrument, the Master of the High Court' or anyone with an interest in the trust assets can apply for an order that instructs the trustee to carry out such duties.[125]

A trust is usually seen as a trading option that provides trustees with limited liability against the *bewind* trust's debts. Trusts provide investors with continuity and any assets they own remain unaffected by the death of trustees. [126] However, although the major reason of setting up a trust is for certainty and continuity, a trust deed can be amended, which leads to a deviation from the intentions of the founder and a change in the expectations of the beneficiaries.[127]

2.3 CONCLUSION

En commandite partnerships and *bewind* trusts constitute the main legal structures of PEIs in SA. Unlike in a company where regulation is set by the Companies Act, the governance of an *en commandite* partnership is set out in the partnership agreement and when PEIs are regulated by a partnership agreement between parties, the uncodified common law of contract plays a particularly significant role. The Roman and Roman-Dutch law laid down the basis of the South African common law and therefore applies in the regulation of PEIs. The major advantage of e*n*

122 Section 6 (1) Trust Property Control Act 57 of 1988.
123 Geach W 'Some topical issues relating to trusts' available at *http://www.mcatv.co.za/files/Download/Trusts_Walter_Geach.pdf* (accessed 20 December 2014).
124 Section 20 (1) Trust Property Control Act 57.
125 Section 19 Trust Property Control Act 57.
126 Geach W 'Some topical issues relating to trusts' available at *http://www.mcatv.co.za/files/Download/Trusts_Walter_Geach.pdf* (accessed 20 December 2014).
127 Geach W 'Some topical issues relating to trusts' available at *http://www.mcatv.co.za/files/Download/Trusts_Walter_Geach.pdf* (accessed 20 December 2014).

commandite partnerships and *bewind* trusts is that they have a tax transparent status that allows investors to be taxed individually and according to the tax profile of each investor.[128] The *en commandite* partnerships are governed by the common law that allows GPs to exercise extensive control over the activities of the private equity funds with few legal obligations. The other advantage of the *en commandite* partnership is that a LP does not incur debts from the partnership in an amount bigger than their capital contribution. The LP maintains the limited liability status by observing the common law requirements. This limitation of the partnership's losses means that the individual assets of the partners are safe from being seized by third parties should the *en commandite* partnership be liquidated. An *en commandite* partnership, also permits LPs to ring-fence risk whilst the GPs, manage investments on their behalf and assume the general unlimited liability.[129] Traditionally, the contractual flexibility of e*n commandite* partnerships permits LPs to have restricted direct control on the activities of fund managers and as a result, have specific monitoring rights over how the legal structure is adminstered.[130] They can also establish advisory boards made up of LPs. In addition, the e*n commandite* partnerships agreements and side letters permit GPs and LPs to enter into contracts that align their goals and lessen opportunism or agency costs. However, as the GPs typically have more inside information it is usually to their benefit to highlight their achievements and tone down potential challenges.[131]

One of the major concerns on *en commandite* partnerships is the failure of the law to recognise the partnership as a separate legal entity and this is seen as possibly its most notable defect.[132] CGT is often also raised as a disadvantage of *en commandite* partnerships. In PEIs, the GPs typically form a different partnership each time the investment phase for the old partnership has been accomplished. At this point the old LPs are considered to have disposed of their interest in the partnership assets and when there is the disposal of shares, tax is often raised. The 'realisation gains are usually treated as being of a capital nature even where the shares were not

128 Marples DJ *Taxation of Hedge Fund and Private Equity Managers* (2014) 3.
129 Verfides 'UK private equity funds: tax-efficient structuring' available at *http://www.verfides.net/images/uploads/PrivateEquity.pdf* (accessed 3 January2015).
130 Sahu R, Nath A & Banerjee P 'Trends in private equity and venture capital investments with special focus on the booming India growth story' (2009) 4 *Journal of International Commercial Law and Technology* 2.
131 Prowse SD *The Economics of the Private Equity Market* (1998).
132 Cassim FHI et al *The Law of Business Structure* (2012) 18.

held for the required three years before the date of disposal.'[133] Another concern of PEIs structured as *en commandite* partnerships involves the significant use of debt in relation to the obscure ownership of economic risks.[134]

In comparison with a juristic person or company, a *bewind* trust is flexible due to its relative lack of statutory formality in its formation and operation.[135] The flexibility of trusts has, however, been cited as the reason they have been abused in the past and as a result are increasingly coming under scrutiny by the courts.[136] Generally the *en commandite* partnership is becoming more popular than the *bewind* trust because they are operated in accordance with international trends and governance methods. In addition, the Exchange Control regulation of 1961, gives a special concession to funds that wish to invest in Africa when they are structured as *en commandite* partnerships, largely because the legal structure of a *bewind* trust is less favoured by the South African National Treasury.[137]

In essence, it is normally of importance that each and every institutional investor carefully considers the private equity fund legal structure before committing to PEIs as it impacts on the tax, liability and risk of the investment. In investment decisions involving pension funds, for instance, it would be imperative to consider the implications of the legal structure of PEIs in relation to the lifetime savings, pensioners'potential liability and the liquidity risk. Although private equity funds are implicitly governed by the common law, there are various and distinct sections of legislation that also regulate the financial activities of PEIs. The next chapter discusses the statutes that are relevant in the financial regulation of PEIs in SA.

133 Mendes A 'Private equity fund structures in South Africa: are there real tax benefits in one structure over the other?' (2009) available at *https://www.ensafrica.com/newsletter/briefs/taxDec09equity.html* (accessed 17 May 2015).

134 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

135 Geach W & Yeats J *Trusts* (2007) 4.

136 *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA), *Jordaan v Jordaan* 2001 (3) SA 288 (C), *Land and Agricultural Bank of South Africa v Parker* 2005 (2) SA 77 (SCA).

137 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa: market and regulatory overview' available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

CHAPTER 3

THE FINANCIAL REGULATION OF PRIVATE EQUITY INVESTMENTS IN SOUTH AFRICA

3.1 INTRODUCTION

Financial regulation is a form of supervision that involves the provision of guidance, directives and the imposition of constraints on financial activities.[138] Its ultimate objective is to achieve a 'high degree of economic efficiency, consumer protection and ensure institutional safety and soundness.'[139] The current state of the financial regulation of the PEI industry is the result of a number of historical changes in SA and in international capital markets.[140] By and large, private equity financial regulation in SA 'makes use of contractual terms or organisational practices that are commonly used internationally' and is also informed by international best practice from institutions that include the International Organization of Securities Commission (IOSCO).[141]

Unlike in most developed economies, in SA, there is no state agency that sets regulatory oversight specifically over PEIs. There is no single statute that regulates PEIs, as is the case in, for example, Mauritius which enacted the Mauritius Limited Liability Partnerships Act 20 of 2011 which regulates private equity in the country. In theory, PEIs in SA could be regulated by a single Act, namely, the Collective Investment Schemes Control Act[142] (CISCA), but the CISCA only regulates a managed pool of capital in which members of the public are allowed to participate. Therefore, PEIs are not regulated by CISCA as they are an administered, collective investment scheme that members of the public participate in as considered in the Companies Act

138 Falkena H et al *Financial Regulation in South Africa* 2 ed (2001) 2.
139 Falkena H et al *Financial Regulation in South Africa* 2 ed (2001) 2.
140 KPMG & SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries- publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).
141 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).
142 Act 45 of 2002.

No. 71 of 2008.[143] In addition, there are views that any efforts to get private equity funds to be regulated by the CISCA would involve complex alterations and justifications which may make the PEIs, as an asset class, less appealing to foreign investors.[144] Therefore, currently, if a private equity fund were to follow the legislative requirements of the CISCA, it would result in the fund being illegitimate and the private equity fund managers being criminally liable.[145]

Although there is no single, holistic or specific legislation governing the PEIs industry in SA, there are various legislative and regulatory rules that regulate the financial transactions of private equity funds. The financial legislative framework of PEIs in SA comprises both statute and common law, which results in a number of different pieces of fragmented legislation and regulatory rules.[146] These include the FAIS Act,[147] B-BBEE Act[148] and the BEE policy framework, the Companies Act,[149] the PFA,[150] the FMA,[151] the Exchange Control Regulations 1961 (the Regulations), Competition Act[152] (the Competition Act), the JSE Listing Requirements and the King Reports on Corporate Governance. This chapter gives an overview of these different pieces of legislation and regulations that govern the financial activities of private equity funds in SA.

3.2 The financial regulation legal framework in South Africa

The financial legislative framework in SA is generally in the hands of the Ministry of Finance. The government department responsible for setting the policy framework with regards to the regulation of private and public sector investments, under the Minister of Finance, is the National Treasury. This is done through 'two main regulators, namely, the South African Reserve Bank

143 Regulation 28 Pension Fund Act 24 of 1956.
144 Knight A & Buys R 'South Africa as a gateway to Africa: foreign member funds in the spotlight' available at South Africa as a gateway to Africa available at *http://www.biznews.com.mailbo/za/news/*2014/04/07*south-Africa-as-a-gateway-to-Africa_unpacking-new-rules-africa-focused-foreign-funds/* (accessed 8 January 2015).
145 Act 45 of 2002.
146 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).
147 Act 37 of 2002.
148 Act 53 of 2003.
149 Act 71 of 2008.
150 Act 24 of 1956.
151 Act 19 of 2012.
152 Act 89 of 1998.

(SARB) and the Financial Services Board (FSB).'[153] The SARB 'formulates and implements the monetary policy, supervises the banking sector and administers exchange controls'.[154] On the other hand, the FSB is a 'regulatory authority for the non-bank financial institutions approved financial institutions and financial services providers'.[155] It regulates institutions, such as, 'pension funds, insurance companies, exchanges, collective investment schemes, friendly societies and financial services providers.'[156] However, there are some categories of investment establishments that are not directly controlled by the FSB. Some examples of investment structures the FSB does not oversee are 'exchange traded funds which are not registered as collective investment schemes' and PEIs structured as partnerships and *bewind* trusts.[157] Therefore, in sum, the FSB does not directly regulate private equity funds in SA. One reason for this is that some private equity transactions are collectively regulated by the same tax and company laws that apply to all other entities that participate in procedures, such as, bidding or buyouts.[158] In addition, PEIs normally do not issue debt or securities on financial markets and are therefore regarded as posing little risk to the financial sector.[159] The other reason why PEIs are generally not regulated is that LPs are well-informed financial or institutional investors who invest through legal partnerships and contracts that safeguard investors.'[160] However, in recent times, PEIs are considered high risk and gradually there are certain regulations that are now being applied globally to private equity funds with the aim of bringing all financial operations under regulatory scrutiny.

3.2.1 The Financial Advisory and Intermediary Services Act (FAIS Act) of 2002

During the financial crisis, privately pooled funds such as PEIs received adverse publicity due to the uncertainty around regulations and this created a challenging fundraising environment for

153 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).
154 Section 10 South African Reserve Bank Act 90 of 1989.
155 Section 3(a) Financial Services Board Act 97 of 1990.
156 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).
157 Bennet A & Loubser J 'South Africa: The asset management review' available at *http://www.mondaq.com/x/209212/asset+finance/The+Asset+Management+Review+South+Africa* (accessed 11 February 2014).
158 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).
159 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).
160 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

them. Policy makers, such as, the Group of 20 (G20) addressed these economic issues and financial threats that made the global and financial markets risky.[161] In accordance with the recommendations made by the G20, the IOSCO published six principles which had to be followed by its Member States to reform the regulatory framework for private equity funds.[162] SA, being a Member of IOSCO, followed the principles by re-enforcing the already existing; fund manager level focused FAIS Act and added an additional layer of the Fit and Proper requirements, late in 2008.[163]

Financial services in SA are regulated by the FAIS Act. Although there is no requirement that a private equity fund should be registered with a government agency, fund managers are generally required to register as financial services providers under the FAIS Act. Therefore, private equity fund managers 'may not act or offer to act as financial services providers unless' they are approved by the Registrar of Financial Services and have the required licence.[164] The FAIS Act also imposes on the approved financial services providers, fiduciary duties that include the duty to provide 'financial services honestly, fairly and with due care, skill and diligence.'[165]

By requiring fund managers to register, the FAIS Act subsequently makes a provision for the disclosure of information on their financial operations and funds. It is mandatory for financial services providers to keep and submit accounting records annually that cover the operations they are authorised to carry out.[166] Financial services providers that are not covered by the Companies Act[167] and the Close Corporations Act,[168] such as private equity firms, are required to include 'at least a balance sheet and notes thereon; an income statement and notes thereon; a statement of changes in equity and notes thereon or a cash flow statement in one of the official languages of SA'[169] The regulations issued under the FAIS Act also state that any unauthorised fund manager

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161 Head JW 'The global financial crisis of 2008-2009 in context- reflections on international legal and institutional failings, fixes and fundamentals' (2011) 23 *Pac McGeorge Global Bus & Dev LJ* 53.

162 G20 *G20 Working Group 1. Enhancing Sound Regulation and Strengthening Transparency* (2009).

163 Mqokiyana N *The Regulation of Hedge Fund Managers in South Africa – An Impact Assessment* (unpublished M Comm, University of Johannesburg, 2011) 84.

164 Section 8 FAIS Act 37 of 2002.

165 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

166 Sections 19 (1) (a) and (b) FAIS Act 37 of 2002.

167 Act 71 of 2008.

168 Act 69 of 1984.

169 Sections 19 (1) (a) and (b) FAIS Act 37 of 2002.

may not in any manner or by any means put out 'advertisements or announcements that are directed at clients or make use of any name, title or designation which would imply that such a person' is an approved services provider.[170]

On 30 May 2014, the FSB made an additional requirement that inhibits the business practice of renting a licence. The provision 'ensures that clients deal with the licensed fund manager even when it is a representative delivering the financial services.'[171] Representatives who act on behalf of a registered adviser, including its officers, directors and control persons, are now also required to register in the relevant individual adviser category. In addition, there are regulatory examinations conducted by the FSB that individuals offering financial services are required to successfully complete.[172] The authorised fund managers are also required by the FSB to comply with an annual fee schedule. A study carried out by Mkoyina[173] indicated that fund managers viewed regulations, such as, the FAIS Act, as crucial, but that the cost associated with compliance was seen to be far higher than the benefits of regulation.

In comparison with listed companies, the FAIS Act places minimal financial requirements on fund managers of PEIs. Although, the FSB can request any information from its regulated entities,[174] non-listed companies, such as, private equity funds, can select how and to what degree they can submit their financial records. Apart from the FAIS Act requirements, private equity fund managers could 'potentially attract liability for contractual misconduct or delict due to fraud, non-performance or negligent misrepresentation arising from the contractual agreements with investors'.[175] However, in SA, to date, 'there is no well-developed body of case law dealing with contractual misconduct or the liability of delict' with regards to PEIs.[176] In sum,

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170 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

171 Sections 13(1) (c) FAIS Act 37 of 2002.

172 Section 8 (1) FAIS Act 37 of 2002.

173 Mqokiyana N *The Regulation of Hedge Fund Managers in South Africa – An Impact Assessment* (unpublished M Comm, University of Johannesburg, 2011) 84.

174 Financial Stability Board 'Progress in the Implementation of G20/FSB Recommendations for South Africa' (2012) available at *http://www.financialstabilityboard.org/wp-content/uploads/r_120619rr.pdf?page_moved=1* (accessed 11 April 2015).

175 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2014).

176 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2015).

the FAIS Act was introduced to support good and proper professional practice in the financial services industry in SA and this includes private equity funds.

3.2.2 The Pension Funds Act (PFA) of 1956

Retirement funds have traditionally preferred to invest in public companies and state securities rather than in the more risky unlisted PEIs.[177] Currently, the biggest investors in the South African private equity market are retirement and endowment funds. 'Of the total ZAR27.3 billion raised by the industry in 2013**,** 85.2% was from pension and endowment funds,' 5.1% from private equity funds and 3.3% from insurance companies.[178] Historically, pension funds in SA limited investment in unlisted equity to a portion of the 5% that was also allocated for other alternative assets. This was mainly due to the 'lack of proper performance data on PEIs, the lack of transparency of PEIs, the risk of PEIs being illiquid, and possibly the general, restricted familiarity with private equity as an asset class.'[179] In March 2011 the Minister of Finance made changes to the prudential limits of the percentage to which pension funds could invest in different asset classes under Regulation 28 of the PFA. In accordance with the amended Regulation 28 of the South African PFA, 'pension funds can now invest up to 10 per cent of their assets in PEIs and up to 15% of their assets in hedge funds and PEIs.'[180]

Regulation 28 requires pension fund managers or trustees to exercise due diligence whenever they invest in PEIs. The pension fund managers or trustees are required to take into account risks (credit, market and liquidity) that are associated with making an investment in an asset class, such as private equity funds.[181] In addition, trustees of pension funds are required to make extensive use of competent advisers in order to safeguard their own interests in any negotiation or contractual agreement.

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177 Mayer C 'Institutional investment and private equity in the UK' available at *www.finance.ox.ac.uk/Papers/FinancialEconomics/index.htm* (accessed 8 November 2015).

178 KPMG & SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries- publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

179 Missankov I, Van Dyk R & Van Biljon M et al. 'Is private equity a suitable investment for South African pension funds?' available at *http://www.itinews.co.za/content/media/companydocs/5f9cc53b-ddf5-4041-8151-2ced3b412681.pdf* (accessed 8 November 2014).

180 Regulation 28 Pension Funds Act 24 of 1956.

181 Regulation 28 Pension Funds Act 24 of 1956.

Regulation 28 defines the term 'private equity fund' as:

> *'a managed pool of capital that:*
>
> *• has as its main business the making of equity, equity orientated or equity related investments in unlisted companies to earn income and capital gains;*
>
> *• is not offered to the public as contemplated in the Companies Act, 2008 (Act No. 71 of 2008);*
>
> *• is managed by a person licensed as a discretionary financial services provider as defined in the Code of Conduct for Administrative and Discretionary Financial Services Providers, 2003, or if a foreign private equity fund, managed by a person licensed as a Category 1Financial services Provider that is authorised to render financial services [in] securities and instruments as defined in the Determination of Fit and Proper Requirements for Financial Services Providers, 2008; and*
>
> *• is subject to conditions as may be prescribed.'*[182]

Generally, although it is mandatory for the advisers and managers of PEIs to be licensed as category 1 financial service providers, which is a less difficult regulatory regime, when dealing with pension funds, the requirement is slightly different.[183] When pension funds are involved and when the PEIs' managers who manage or advise the private equity funds are domiciled in SA, they are required to hold category II financial service provider licences, which have more onerous requirements.[184]

In addition, Regulation 28 of the PFA makes provision for the Registrar of Pension Funds to impose additional conditions on investments made in *en commandite* partnerships or *bewind* trusts. The Registrar of Pension Funds published these additional requirements or conditions that came into effect on 31 December 2012.[185] Therefore, pension funds in SA follow the requirements set out in the 'Schedule on Conditions for Investment in Private Equity Funds'[186]

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182 Regulation 28 Pension Funds Act 24 of 1956.

183 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at http://uk.practicallaw.com/4-376-4687 (accessed 3 January 2015).

184 Roderick L, Kennedy-Good S &Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at http://uk.practicallaw.com/4-376-4687 (accessed 3 January 2015).

185 Section 5(2) (e) Pension Funds Act 24 of 1956.

186 Conditions for Investment in Private Equity Funds in terms of S 5(2) (e) Pension Funds Act 24 of 1956.

which is regulated by the FSB. Although these requirements are not mandatory, PEIs comply with them in order to appeal to the major investors in the country, which are pension funds.[187]

The Schedule on Conditions for Investment in Private Equity Funds states that the permissible legal structures for private equity funds in SA include *en commandite* partnerships, which would make the pension fund a LP as discussed in Chapter 2. The second legal structure that is prescribed by the Registrar of Pension Funds is the *bewind* trust in which pension funds become 'co-owners in undivided shares of the trust assets and are only beneficiaries and not trustees.'[188] Pension funds may also invest in companies whose 'assets and liabilities are limited to the assets and liabilities arising from their private equity investments.'[189] The Registrar of Pension Funds also recommends 'partnerships, open-ended investment companies or companies in which the assets and liabilities are limited to the assets and liabilities arising from the investments made by the private equity fund' for foreign investments.[190]

The fund managers of the PEIs that pension funds can invest in are further required to be members of an industry body recognised by the Registrar of Pension Funds, SAVCA.[191] In addition, fund managers are required to be authorised under the FAIS Act.[192] The pension fund managers also have to consider a list of prescribed due diligence matters before investing in PEIs. These matters include the compliance policies and procedures, the investment strategy, the associated risks and the carried interest or fees charged by the PEIs.[193] The fund managers of PEIs are required to submit audited financial statements that comply with the International Financial Reporting Standards (IFRS) to pension funds within a period of 120 days.[194] The private equity fund's assets are required to be audited every six months.[195] Private equity funds

187 Roderick L, Kennedy-Good S &Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).
188 Condition 2 (1) Section 5(2) (e) Pension Funds Act 24 of 1956.
189 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).
190 Bowman Gilfillan 'Conditions for investment in private equity funds' available at *http://www.bowman.co.za/eZines/Custom/PrivateEquity/Newsflash/Investment-in-Private-Equity-Funds.html* (accessed 4 March 2015).
191 Condition 2 (2) Regulation 28.
192 Condition 3 (1) Regulation 28.
193 Condition 7 Regulation 28.
194 Condition 9 (1) Regulation 28.
195 Condition 6 Regulation 28.

in SA are required to have 'clear policies and procedures for determining the fair value of their assets in compliance with the International Private Equity Valuation Guidelines.'[196]

The Registrar of Pension funds also requires PEIs to submit to retirement funds performance reports in periods that are not more than three months. Pension fund trustees are also required to consider 'the investment and borrowing powers of the private equity fund, its sources of debt, redemption rights, and the ownership of the assets in the fund,'[197] before investing in it. Another essential factor that the pension trustees also need to consider before investing in PEIs is 'the liquidity profile of the private equity fund relative to the liquidity requirements and liability profile of the pension fund.'[198]

Pension funds as the biggest percentage of investors in SA influence the regulation of PEIs significantly. In addition, the PFA particularly aims to protect members of the public who contribute collective saving funds to, and purchase pension products, from pension schemes. This is also evidenced by the legal structures for PEIs that the PFA recommends. The legal structures ensure that retirement funds have the limited liability status against the creditors' claims. The Conditions for Investment in Private Equity Funds have considerably influenced the contractual terms and regulatory framework of PEIs that strive to be entrusted with retirement funds in SA[199] and pension funds have continued to be a major source of capital for PEIs.

3.2.3 The Broad-Based Black Economic Empowerment (B-BBEE) Act of 2003

The BEE, is defined as 'the economic empowerment of all black people, including women, workers, youth, people with disabilities and people living in rural areas, through diverse but integrated socio-economic strategies'.[200] Its guiding framework is the Financial Sector Charter, which aims to increase transformation and equitable growth in the economy.

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196 Condition 8 Regulation 28.

197 Bowman Gilfillan 'Conditions for investment in private equity funds' available at *http://www.bowman.co.za/eZines/Custom/PrivateEquity/Newsflash/Investment-in-Private-Equity-Funds.html* (accessed 4 March 2015).

198 Bowman Gilfillan 'Conditions for investment in private equity funds' available at *http://www.bowman.co.za/eZines/Custom/PrivateEquity/Newsflash/Investment-in-Private-Equity-Funds.html* (accessed 4 March 2015).

199 Section 5(2) (e) Pension Funds Act 24 of 1956.

200 The Broad-Based Black Economic Empowerment Act 53 of 2003.

The PEIs industry facilitates BEE by promoting entrepreneurial initiatives and providing for the involvement of Blacks and other historically disadvantaged groups in the ownership and management of investee companies.[201] In addition, compliance with the B-BBEE Act is imperative, particularly for those firms whose income comes from B-BBEE compliant companies, government entities and state departments. Although the B-BBEE Act and The Codes of Good Practice of the B-BEE Act (the Codes) do not impose legal obligations on funds, the B-BBEE status is an essential factor in entering into partnerships between public and private entities, dealing with JSE listed companies, applying for licences or concessions, tendering for business or buying state-owned assets.

The Ministry of Trade and Industry published the amendments to the Codes for private equity funds on 11 October 2013.[202] They influence the private equity industry by stating the circumstances in which a portfolio company may regard ownership made by PEI firms as if it were held by Black people.[203] The amendments are aimed at promoting Black, private equity fund management and therefore target mainly PEIs fund managers as well as the funds themselves. The amendments also provide incentive for investee companies to benefit from funds from PEIs with Black fund managers in order for them to get a better B-BBEE rating.[204] The private equity fund manager is required to invest a proportion of the total amount of its 'funds under management in companies that have at least a 25% black shareholding.'[205] The Codes allow investee companies to consider equity 'held by PEIs as being held by Black persons if, among other things,'[206]

- *'at least 51% of any of the votes held by that fund's private equity fund manager in the underlying portfolio company are held by black persons.*

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201 KPMG & SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

202 Section 9 (1) Broad-Based Black Economic Empowerment Act No. 53 of 2003.

203 General Notice 112 of 2007, 29617 of 9 February 2007.

204 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the 2012 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2013.aspx* (accessed 5 November 2014).

205 Cunard D 'Code amendment gives BEE impetus to private equity funds' available at *http://www.iol.co.za/business/opinion/code-amendment-gives-bee-impetus-to-private-equity-funds-1.1690633#.VVxoUkbvrIU* (accessed 20 May 2015).

206 Paragraph 5 the Codes 26.

- *at least 51% of the private equity funds executive management and senior management is made up of black persons;*

- *at least 51% of the profits made by the Private Equity Fund Manager after realizing any investment made by it must by written agreement accrue to black persons; and*

- *the fund manager is a company owned by black Persons*.'

The amended generic Codes of Good Practice[207] that came into effect on the 1 May 2015 provide a new standard framework for determining compliance to the B-BBEE Act across all sectors of the economy and illustrate how the different amounts of the scorecard are to be measured in companies. Previously, it was not clear how an entity's B-BBEE status would be evaluated, but the recently published amendments to the Codes provide that the sector-specific B-BBEE status of a company remain the measuring yardstick for B-BBEE and should be measured according to a rating scale for the relevant sector.[208] Therefore the above discussed Sector Codes of the private equity funds as published in 2013 are still maintained for the industry. However, with regards to PEIs regulation, it is also important to fully understand how ratings of portfolio companies will be affected by the new generic Codes. In order for an entity to maintain a specific B-BBEE status it now needs to reassess its B-BBEE strategy as the points required to attain previous B-BBEE levels have been increased. This is especially imperative for portfolio companies which are expected to have a certain minimum B-BBEE status by their clients or where contractual obligations require them to maintain a minimum B-BBEE status.[209] In addition, companies may need to attain a certain B-BBEE rating before they can be issued a permit, licence, or other authorisation.[210] Other notable changes include that the overall amount of points that can be scored has gone up from 107 to 118, treatment of a company that is 51%-or-

207 Broad-Based Black Economic Empowerment Generic Codes of Good Practice Amended Codes of Good Practice, gazette No. 36928.

208 Werksmans Attorneys 'Amendments to the BBBEE Act and the Codes explained' (2014) available at *http://www.werksmans.com/wp-content/uploads/2014/11/041763-WERKSMANS-bbbee-booklet.pdf* (accessed 17 May 2015).

209 Cunard D 'Code amendment gives BEE impetus to private equity funds' available at *http://www.iol.co.za/business/opinion/code-amendment-gives-bee-impetus-to-private-equity-funds-1.1690633#.VVxoUkbvrIU* (accessed 20 May 2015).

210 Cunard D 'Code amendment gives BEE impetus to private equity funds' available at *http://www.iol.co.za/business/opinion/code-amendment-gives-bee-impetus-to-private-equity-funds-1.1690633#.VVxoUkbvrIU* (accessed 20 May 2015).

more black-owned as if it were 100% black owned, and discouraging fronting practices.[211] In addition, a limit is now placed on the points scored under the management control and skills development to economic active population targets for African, Indian and Coloureds and it is now more difficult for large companies to achieve targets on management control and skills development.[212]

While the new amendments still encourage new black entrants to the fund management industry, the treatment of BEE in private equity has been slightly different from that of other entities. This different treatment of PEIs has always raised concerns of new types of fronting practices. These practices are formal arrangements that appear to be B-BBEE compliant when in fact are non-compliant when scrutinised closely. The PEIs industry awaits to see if the new Codes published, which came into effect in May 2015, will completely eliminate the problem of fronting practices. All sectors of the South African economy are now required to comply with B-BBEE legislation hence B-BBEE transactions are now widespread. The BEE framework and B-BBEE transactions have therefore also had a huge impact in private equity transactions, particularly in the regulation of fund managers and, to a lesser extent, the funds themselves.

3.2.4 Companies Act 71 of 2008

The Companies Act has an indirect effect on *en commandite* partnerships and *bewind* trusts. It regulates transactions, such as IPOs, and the takeover regime as well as fund managers who are incorporated in SA. It is also relevant to the management of portfolio companies and to PEIs that are in a corporate legal structure. The Companies Act addresses issues, such as, 'the incorporation, registration, organisation and management of the portfolio companies, impartial and well-organised amalgamations, company takeovers and mergers.'[213] In general, private

211 Werksmans Attorneys 'Amendments to the BBBEE Act and the Codes explained' (2014) available at *http://www.werksmans.com/wp-content/uploads/2014/11/041763-WERKSMANS-bbbee-booklet.pdf* (accessed 17 May 2015).

212 Werksmans Attorneys 'Amendments to the BBBEE Act and the Codes explained' (2014) available at *http://www.werksmans.com/wp-content/uploads/2014/11/041763-WERKSMANS-bbbee-booklet.pdf* (accessed 17 May 2015).

213 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

equity funds do not own all of the shares they acquire in companies, but own a stake that is big enough for them to decide who sits on the investee company's board of directors.[214]

When PEIs are made in listed companies with the intention of making them private, that is, a buyout, a transaction such as this is mainly governed by the Companies Act. The common law fiduciary duties that a private equity fund which sits on the board of directors is subject to, include the 'duty to exercise independent judgment, the duty to avoid conflicts of interest and the duty to act in the shareholders' best interests.'[215] These fiduciary duties, which were formerly regulated by the common law and seek to ensure 'transparency, higher levels of corporate governance and accountability' in South African companies, have been partially codified in the Companies Act.[216] The ccommon law duty of care and skill in business judgements have been in partially codified in the Companies Act. According to the Act, when a director makes a decision in good faith, with care and on an informed basis, thinking that it is in the best interest of the company, they cannot incur liability in respect of the decision.[217]

Directors, in the amended Companies Act, now have an additional duty to disclose financial interests that arise personally or through a related person. [218] When a director either personally or through a related person has an interest in a financial matter being discussed in a board meeting, the transaction is required to be disclosed in writing before the matter is considered.[219] This provision in the Companies Act stresses the importance of transparency and accountability. When private equity firms sit on the board of directors of investee companies they risk breaching the prescribed directors' duties if they behave in a way meant to help their shareholding without upholding the stakeholder model. In addition, while there used to be less difficult accounting requirements for private companies, the Companies Act now requires all accounting statements to be prepared according to the International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) accounting standards.[220]

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214 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement'(2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).
215 Ramani N *Corporate Governance: An Essential Guide for SA Companies 2* ed (2009) 175.
216 Section 76 (3) Companies Act 71 of 2008.
217 Section 76 (3) Companies Act 71 of 2008.
218 Section 75 Companies Act 71 of 2008 (amended).
219 Ramani N *Corporate Governance: An Essential Guide for SA Companies 2* ed (2009) 175.
220 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com*

When a private equity fund makes an offer to make a public takeover of a company, the process is highly regulated by the JSE Listing Requirements and the Takeover Regulations of the Companies Act. Therefore, private equity funds in their financial transactions with a target company listed on the JSE are required by the South African law to observe the general disclosure requirements.[221] The private equity fund transactions are required to comply with 'the form and conduct of offers, the announcements, asset valuations, mandatory offers, equal treatment of shareholders and the disclosure of information.'[222]

The Companies Act provides that shareholders in a takeover should be notified and must approve of the takeover of a bigger part or all of a target portfolio company's assets. It also provides for the 'compulsory acquisition of minority shareholdings when an offeror acquires 90 per cent of total equity in the target investee company.'[223] However, the business rescue arrangement that is in accordance with Chapter 6 of the Companies Act provides for another circumstance which does not require a special resolution.[224] The Takeover Regime in the Companies Act imposes a number of restrictions on transactions involving public companies and those entities identified as regulated companies. The Companies Act's Takeover Regulations[225] set the formalities that are required to be followed when PEIs are involved in an affected transaction under the takeover regime. In relation with a private equity fund, an affected transaction would include, 'an offer to purchase shares, the purchase of a company as a going concern or a scheme of arrangement.'[226] The disclosure requirements for a takeover offer and a members' scheme of arrangement include the disclosure of the details of the private equity funds' or 'bidder's intentions and prospectus, the funding arrangements for cash consideration' and all details that a bidder has and that may be essential for the shareholders to make a decision.[227]An example is when the private equity firm

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(accessed 19 November 2014).

221 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

222 Roderick L, Kennedy-Good S &Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

223 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

224 Section 112 (2) Companies Act 71 of 2008.

225 Sections 117- 127 Companies Act 71 of 2008.

226 Roderick L, Kennedy-Good S &Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

227 Bassiil R & Cook P 'Private equity getting the deal, Australia' (2012) available at *http://www.gtlaw.com.au/wp-*

making the IPO is already an insider of the target company or makes the bid acting jointly with insiders, such as with senior management of the target company. The bidder is prohibited from procuring shares until the inside information is made public or stops being material.

Private equity funds normally can take over a public company when the company is either profoundly under-valued by the market or when the companies business strategy is inconsistent with the JSE requirements. From the foregoing discussion it is clear that the Companies Act and the associated regulatory provisions, such as the JSE Listing Requirements, have considerable influence on the functioning of private equity transactions, such as, takeovers and IPOs. The challenge now would be harmonising it with other regulatory instruments so that a consolidated framework for regulating PEIs is developed.

3.2.5 Competition Act 89 of 1998

The regulation of PEIs in SA is influenced by the Competition Act. PEIs are subject to the Competition Act particularly when there is merging of portfolio companies. When a private equity fund is involved in a merger as defined by the Competition Act it is required to inform the competition authorities of the specific transaction. A transaction of this nature is subject to the Competition Act when it involves portfolio companies that meet the 'asset and turnover thresholds established in terms of the Act.'[228] The transaction is also required to have an effect within SA. If a private equity fund is involved in a foreign merger, the provisions of the Act apply only to the 'extent that the foreign investors have assets in SA or to the extent that their turnover or sales are generated in, into or from SA.' [229]

The Competition Act provides for a number of exploitations that may be carried out by big companies which have a 'market share of 35% or more' and prohibits anti-competitive conduct'.[230] Some forms of market abuse that the Act prohibits include predatory pricing,

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content/uploads/2012/04/Getting-the-deal-through-Transactions-2012.pdf (accessed 10 January 2015).

228 Section 12 Competition Act 89 of 1998.

229 Modise L, Makola M &Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2013).

230 Competition Act 89 of 1998.

collusive tendering and price fixing.'[231] The Department of Economic Development in SA monitors the enforcement framework of the Competition Tribunal and Competition Commission. The authorities in reaching their verdicts can take into account both economic competitiveness and the broad community concerns that include the B-BBEE. Consequently, the Competition Act helps to bring fair competition within the private equity industry in SA.

3.2.6 The Financial Markets Act 19 (FMA) of 2012 and JSE Listing Requirements

When a private equity firm needs to carry out an IPO there is a high level of corporate governance and disclosure with regards to the board of directors. In order to meet the listing requirements, when offering shares to potential shareholders, PEI firms cannot give misleading details or omit mandatory information as this attracts statutory liability with considerable fines. The statutory liability includes all parties involved in the 'listing or the preparation of the prospectus, including deemed personal liability of current or proposed directors.'[232] Since 2013, market abuses, such as, 'insider trading, manipulative, improper, false or deceptive trading, and the making of false, misleading or deceptive statements, promises and forecasts,' are now regulated by the FMA.[233] The regulatory framework of the JSE Listing Requirements and the FMA seek to protect consumers from making bad decisions by ensuring that everyone gets all relevant information on the stock exchange. Information is regarded as public when it is disseminated on the appropriate channel, which is the JSE's Stock Exchange News Service (SENS), for all registered brokers to access it. Once inside information is eliminated, insider trading is also eliminated.[234]

The JSE set the Additional Listings Requirements to deter the use of inside information in the dealings carried out by company directors. A director is not permitted to deal in shares that relate to an issuer before obtaining approval from the Chairman of the Board or an appointed director. Directors are also required to seek approval when they wish to deal during a 'prohibited period.'

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231 Competition Act 89 of 1998.

232 Bassiil R & Cook P Private Equity 2012 Getting the deal, Australia available at *http://www.gtlaw.com.au/wp-content/uploads/2012/04/Getting-the-deal-through-Transactions-2012.pdf* (accessed 10 January 2015).

233 Act 19 of 2012.

234 Cassim R 'Some aspects of insider trading- has the Securities Services Act 36 of 2004 gone too far?' (2007) 19 *SA Merc LJ* 53.

A prohibited period is a time period when there is 'unpublished price sensitive information in relation to the issued securities, whether or not the director has knowledge of it.'[235] According to the JSE Listings Requirements when a portfolio company plans to undertake transactions that may impact the price of a target or acquiring company's shares, the portfolio company is required to make public declarations of such information. To avoid insider trading whenever considered necessary, all firms participating on the stock exchange are required to declare information that may influence share prices prior to its publication on SENS.[236] In addition, although sustainability is not a feature of the Companies Act, the JSE Listing Requirements and the King III Report require companies to ensure sustainability is incorporated in their decision making and to account for their own sustainability.[237]

The FMA aims to enhance the control of dealings in shares listed on the stock exchange as well as over-the-counter transactions.[238] It is clear that its intention is to promote investor confidence and transparency; however, data vendors such as I-Net Bridge and McGregor BFA fear it could increase risk for market participants.[239] The FMA's legislative and regulatory frameworks complies with the recommendations of international standard setting bodies, such as, the G20, the IOSCO, the Financial Stability Board and the Basel Committee on Banking Supervision.[240] According to financial analysts, the JSE remains appealing under the FMA governance and foreign investors and issuers find it akin to international financial markets in other G20 jurisdictions.[241] There is more effective regulation of the stock exchange under the regulation of FMA and the JSE Listing Requirements but the major challenge may be compliance and enforcement thereof. It remains to be seen how South African courts will decide on complex matters raised in the FMA.

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235 *JSE Insider Trading Booklet* (2013)12.

236 Section 78(4) of the FMA.

237 Loots & Shah *Sustainable capitalism, corporate reporting and the role of the accounting profession in SA Corporate Report* (2013) 6.

238 Act 36 of 2004.

239 FSP Invest 'SA's new Financial Markets Act gets data vendors hot under the collar' available at *http://fspinvest.co.za/articles/latest-news/sas-new-financial-markets-act-gets-data-vendors-hot-under-the-collar-707.html#.UntLI22bGZQ* (accessed 7 February 2013).

240 Loggerenberg C 'South Africa's developing financial markets regulation' available at *http://www.iflr.com/Article/3093933/South-Africas-developing-financial-markets-regulation-analysed.html* (accessed 5 November 2014).

241 Loggerenberg C 'South Africa's developing financial markets regulation' available at *http://www.iflr.com/Article/3093933/South-Africas-developing-financial-markets-regulation-analysed.html* (accessed 5 November 2014).

3.2.7 The King Reports

Corporate governance in portfolio companies and in PEIs structured as companies has been influenced by the provisions of the Companies Act and the King Reports on corporate governance. The Global Reporting Initiative[242] has influenced the reporting of portfolio companies' efforts particularly as regards corporate governance.[243] Corporate governance reforms in SA that are aimed at improving the existing standards of corporate governance are found in the common law, the Companies Act, related legislation and the King Reports. The King Reports on corporate governance in SA were not specifically driven by corporate scandals as in the United Kingdom but by the need to be internationally competitive.[244]

The recommendations in the King 1 Report influenced the amendment of the JSE Listing Requirements' Schedule 22 which supported corporate social responsibility through the Code of Corporate Practices and Conduct. In addition, the King 1 Report considered the implementation of affirmative action and the implementation of the BEE framework by firms as good corporate governance practice.[245] The King II Report introduced the concept of triple bottom line reporting, that is, financial, social and environment sustainability performance. Portfolio companies are required to report on issues, such as, ethics, health, environment and transformation issues, including the development of employees and black economic empowerment.[246] These recommendations were in accordance with the major legislative initiatives, such as, 'the Employment Equity Act,[247] the Skills Development Act[248] and the BEE Commission Report in SA.'[249]

242 The Global Reporting Initiative 'An overview of GRI' *available at* http://www.globalreporting.org/information/about-gri/what-is-GRI/Pages/default.aspx (accessed 10 January 2015).

243 Hamann R 'Corporate social responsibility, partnerships, and institutional change: The case of mining companies in South Africa' (2004) 28 *National Resources Forum* 285.

244 Mongalo T 'The emergence of corporate governance as a fundamental research topic in South Africa' (2003) *120 SALJ190* 178.

245 Mongalo T 'The emergence of corporate governance as a fundamental research topic in South Africa' (2003) 120 *SALJ*190 189.

246 Ramani N *Corporate Governance: An Essential Guide for SA Companies* 2 ed (2009) 32.

247 Act 55 of 1998.

248 Act 97 of 1998.

249 Mongalo T 'The emergence of corporate governance as a fundamental research topic in South Africa' (2003) 120 *SALJ*190 190.

The King III Report came into effect in March 2010. It is a JSE requirement for PEI transactions such as IPOs or delisting to be executed in accordance with the recommendations made in the King III Report and the Code. The King III Report recommends 'a holistic and integrated annual reporting that gives sufficient details concerning the company's triple-bottom line requirements and how a company upholds the principles of fairness, transparency and disclosure.'[250] The Report further recommends that communication channels should be accessible and transparent to allow shareholders to make valid choices and meet JSE Social Responsibility Index requirements.[251]

The King III Report is the stakeholder inclusive corporate governance approach and directors are required to strive to balance the 'legitimate interests and expectations of the company's' various stakeholder groupings when making decisions.[252] The King III Report recommends that even if the stakeholder interests and expectations are not considered warranted or legitimate, they should not be ignored.[253] Although the King III Report is not a binding, hard law instrument, failure to comply with it may be an indication that the board of directors is not following the stakeholder model, as in the case of *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd & Others.*[254] Although judgement given concentrated on the resignation of directors, the issue highlighted was to whom the directors owe their fiduciary duties when managing entities.[255] The judgement is important in the sense that it gave specific recognition to environmental concerns, which is one of the triple-bottom line aspects.[256] Good corporate governance practices also require that directors should declare their financial interests which can impair their objectivity in matters involving portfolio companies. The King III Report requires that directors should identify potential conflicts inherent in certain transactions and avoid them or disclose them in detail to the Board to allow it to formulate on how to manage them.[257]

250 Cassim et al *Contemporary Company Law* 2 ed (2012) 503.
251 King M *Synergies and Interaction between King III and the Companies Act 61 of 2008* (2010) 453.
252 King *M Synergies and Interaction between King III and the Companies Act 61 2008* (2010) 448.
253 Cassim et al *Contemporary Company Law* 2 ed (2012) 497.
254 *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd & Others* 2006 (5) SA 333 (W).
255 Luiz S & Taljaard Z 'Mass resignation of the board and social responsibility of the company: *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd*' (2009) 21 *SA Merc LJ* 424.
256 Luiz S & Taljaard Z 'Mass resignation of the board and social responsibility of the company: *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd* '(2009) 21 *SA Merc LJ* 425.
257 Ramani N *Corporate Governance: An essential guide for SA Companies* 2ed (2009) 174.

3.2.8 The Exchange Control Regulations 1961 (the Regulations)

When private equity funds invest outside SA they are required by the Regulations to seek to exchange control approval.[258] Private equity funds' foreign funders and LPs also require the approval of exchange control when there is a transfer of capital and profit. The Regulations require that any capital transferred cross the border by PEI firms be authorised by the SARB, whether it is direct or indirect. In relation to portfolio companies, financial dealings between a subsidiary in SA and a foreign or parent company outside SA are treated as being between a resident and non-resident, and should be approved by SARB.

In the past, private equity funds could not get upfront approval for investments made outside of SA. South African private equity firms that invest in Swaziland, Lesotho and Namibia are no longer required to get authorisation for each and every investment. Such authorisations are required to be renewed after every three years. [259]

Exchange controls in SA are administered by the 'Financial Surveillance Department (FSD) of the SARB and authorised dealers' such as commercial banks which authorise transactions in certain specified circumstances.[260] When South African private equity fund managers form parallel offshore structures, the foreign LPs and local South African LPs form a private capital pool that is managed by a single GP. All offshore financial transactions by PEIs, 'including any terms of repayment, interest rates and draw-downs are required to be authorised by SARB.'[261] Consequently, the increase in private equity offshore structures is viewed to be a 'direct result of the South African exchange control restrictions and various reasons relating to South African tax legislation.'[262]

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258 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

259 Knight A & Buys R 'South Africa as a gateway to Africa: foreign member funds in the spotlight available at South Africa as a gateway to Africa' available at *http://www.biznews.com.mailbo/za/news/2014/04/07south-Africa-as-a-gateway-to-Africa_unpacking-new-rules-africa-focused-foreign-funds/* (accessed 8 January 2015).

260 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

261 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).

262 Knight A & Buys R 'South Africa as a gateway to Africa: foreign member funds in the spotlight available at South Africa as a gateway to Africa' available at *http://www.biznews.com.mailbo/za/news/2014/04/07south-Africa-as-a-gateway-to-Africa_unpacking-new-rules-africa-focused-foreign-funds/* (accessed 8 January 2015).

3.3 CONCLUSION

This chapter sought to review the legislation and regulation applicable to private equity transactions or operations in SA. The financial legislative framework of PEIs in SA comprises both statute and common law, which results in a number of different pieces of separate legislation and regulatory rules.[263] The various statutes and regulations that apply to PEIs include the FAIS Act ,[264] the B-BBEE Act [265]and the BEE policy framework, the Companies Act,[266] the PFA,[267] the FMA,[268] the Regulations, the Competition Act, JSE Listing Requirements and the King Reports on Corporate Governance. A review of these diverse regulatory pieces of legislation shows that they all variably influence the PEIs industry. However, the diverse regulatory rules from different statutes can create an obscure system that may be manipulated and may make enforcement difficult. The statutes are not only fragmented but there is uncertainty if, for instance, the provision on financial products in the FAIS, applies to PEIs structured as *en commandite* partnerships or *bewind* trusts. The interest of investors in *en commandite* partnerships and *bewind* trusts which provides the investor with undivided ownership in the shares of portfolio companies is not a 'security' or 'instrument', but could amount to a 'combined product containing' financial products,[269] such as the shares acquired in the portfolio company.[270] The cautious approach of the PEIs industry has been to market this interest within SA to authorised or licensed fund managers under FAIS.[271] However, it is for such reasons that, it is essential to have a clear, consolidated and comprehensive Act or regulatory framework that regulates the activities unique to the private equity industry. It also gives the 'regulatory authorities powers to intervene in the industry, should a problem arise and bring back stability to the financial sector'[272]

263 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at *www.gettingthedeal.com* (accessed 19 November 2014).
264 Act 37 of 2002.
265 Act 53 of 2003.
266 Act 71 of 2008.
267 Act 24 of 1956.
268 Act 19 of 2012.
269 Definition of 'financial product' in Section 1 of the FAIS of 2002.
270 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2015).
271 Board Notice 80 of 8 August 2003: General Code of Conduct for Authorised Financial Services Providers and Representatives, Paragraph 2.
272 Brown G 'Lord Myners questions proposed EU hedge funds regulations' *Birmingham Post- Business News* September 8 2009.

Regulation 28's Conditions for Investment in Private Equity Funds[273] of the PFA provides an ideal framework to be complied with by retirement funds that wish to invest in PEIs. However, the conditions regulate the conduct of pension trustees and legally, PEIs are not required to incorporate them in all their partnership agreements. The prescribed Conditions also show that South African pension funds are, in fact, able to structure their specific PEIs in accordance to their own inclinations. This is viewed as a feature that can result in a number of regulatory challenges and 'risks that could be potentially hazardous for some smaller, classes of investors.'[274]

On a positive note there is a robust regulatory framework for financial markets in SA that is applicable to PEI activities which include IPOs, mergers and takeovers or buyouts. The regulatory measures in the FMA, JSE requirements and Companies Act are intended to offer essential structures to prohibit securities market abuse by the GPs without deterring growth and sustainability. To this day civil liability under FMA and its predecessors has been more successful in curbing insider trading in SA.[275] This enhances investor confidence in South African PEIs as the effective regulation of PEIs involves both the standards imposed on public and private companies and the financial services regulatory requirements that are imposed directly on PEIs.[276] Ideally these should function optimally and complement each other to encourage investment in PEIs in SA. However, determining and enforcing insider trading in the complex transactions of PEIs and amongst the various parties involved in the specific operations of PEIs may require centralised oversight.[277] In sum, the 'effectiveness of the FMA legislation and its predecessors to a large extent makes the South African regulatory framework one of best legislation in dealing with insider trading.'[278]

Generally, private equity offers funds an opportunity to avoid the over-regulated approach to listed companies. However, internationally the regulatory requirements affecting the asset management industry and private equity funds in particular, have constantly been improved by

273 S 5(2) (e) Pension Funds Act 24 of 1956.
274 McCahery A.J & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag Gov* 197.
275 *JSE Insider Trading Booklet* (2013) 4.
276 Cumming D & Walz U 'Private equity returns and disclosure around the world' (2010) 41 *Journal of International Business Studies* 730.
277 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag Gov* 230.
278 Richard Jooste 'Insider dealing in South Africa' (1990) 107 *SALJ* 589.

the relevant legislators or officials. Although registration of PEIs with a state agency is not yet mandatory in SA, the global reforms of private equity funds' regulations are viewed as a means of bringing the privately pooled funds into the regulatory system. In addition, the FSB has taken significant steps to monitor transactions as well as specific, strategic parties, such as fund managers, in the financial services industry. However, it is mostly the GPs, and not the private equity fund itself, that are regulated by the FSB. This, coupled with the fragmented regulatory framework, might compromise effective regulation of the private equity industry in SA. There might be a need for SA to draw from other countries whose private equity industries have been consistently performing well in recent years. The next chapter discusses the regulation of PEIs in the UK in comparison with that of South Africa.

CHAPTER 4

A COMPARATIVE ANALYSIS BETWEEN THE FINANCIAL REGULATION OF PRIVATE EQUITY INVESTMENTS IN SOUTH AFRICA AND THE UNITED KINGDOM

4.1 INTRODUCTION

The UK is the leading 'European jurisdiction in the management' of PEIs and 'it is second only to the US in terms of global importance.' (Table 4.1)[279]

Table 4.1: Private equity deal value for the year 2012

Country ranking - Deal Value during 2012(uS$ million)								
1	United States Of America	171 180	11	Czech Republic	6 376	21	Netherlands	3 866
2	United Kingdom	32 869	12	Cayman Islands	5 173	22	India	3 741
3	Germany	19 587	13	China	5 093	23	Brazil	3 722
4	France	11 897	14	Finland	4 566	24	Spain	3 626
5	Belgium	9 317	15	Bermuda	4 496	25	Norway	2 868
6	Italy	8 351	16	Denmark	4 399	26	Poland	2 300
7	Egypt	7 676	17	Luxembourg	4 361	27	**South Africa**	1 600
8	Russian Federation	7 250	18	Australia	3 963	28	Switzerland	1 547
9	Sweden	6 807	19	Korea Republic Of	3 903	29	Dominican Republic	1 420
10	Canada	6 504	20	Japan	3 879	30	Israel	1 339

Source: KPMG & SAVCA Survey Report[280]

279 British Private Equity and Venture Capital Association 'Private equity explained' available at http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx (accessed 10 January 2015).

280 KPMG and SAVCA 'Venture capital and private equity industry performance survey of South Africa covering the

According to the 'British Private Equity and Venture Capital Association's (BVCA) Performance Measurement Survey of 2011, there are 501 funds that are managed in the UK' and the British private equity funds' performance data is the most comprehensive dataset to date.[281] It would therefore be of interest to review the UK private equity industry and draw lessons for the improvement of the South African private equity industry.

The Financial Services and Markets Act 2000 (FSMA) that was amended by the Financial Services Act in 2012 is the most relevant Act with regards to PEIs in the UK. However, the FSMA is a framework Act only, and much of the detail is found in subordinate legislation, such as that relating to the Financial Conduct Authority (FCA). PEIs used to be regulated by the Financial Services Authority (FSA). The contract between the private equity fund and the fund manager was subject to the FSA requirements.[282] The FSA was abolished with effect from 1 April 2013 and its provisions were divided among the Prudential Regulation Authority (PRA), the FCA and the Bank of England. The PRA governs the supervision of credit unions, insurers, banks, building societies and major investment firms. It oversees the prudential regulation of financial services alongside the FCA twin peaks regulatory structure.[283] The FCA is responsible for regulating the manner business is carried out by all firms, including in entities that are controlled by the PRA.[284] The Bank of England maintains monetary and financial stability in the UK.[285]

This chapter reviews the key British legislation regulating PEIs in comparison with the South African regulatory system. A brief summary of the UK's private equity legal structure is first provided in order to contextualise the discussion of the UK regulatory system.

2013 calendar year' available at *http://www.kpmg.com/za/en/issuesandinsights/articlespublications/general-industries-publications/pages/private-equity-survey-2014.aspx* (accessed 5 November 2014).

281 British Private Equity and Venture Capital Association 'Private equity explained' available at *http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx* (accessed 10 January 2015).

282 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

283 Bank of England 'Prudential Regulation Authority' available at *www.bankofengland.co.uk/pra/Pages/default.aspx* (accessed 31 March 2015).

284 Bank of England 'Prudential Regulation Authority' available at *www.bankofengland.co.uk/pra/Pages/default.aspx* (accessed 31 March 2015).

285 Bank of England 'Prudential Regulation Authority' available at *www.bankofengland.co.uk/pra/Pages/default.aspx* (accessed 31 March 2015).

4.2 REGULATION OF PRIVATE EQUITY INVESTMENTS IN THE UNITED KINGDOM IN COMPARISON WITH SOUTH AFRICA

4.2.1 Brief review of the private equity legal structure in the UK

The review of the South African private equity legal structures discussed in Chapter 2 showed that the main legal structures are the *en commandite* partnerships and *bewind* trusts of which the structure mainly used is the *en commandite* partnership. In SA an *en commandite* partnership does not have a separate legal *persona* from the partners that set it up.[286] The *en commandite* partnership is governed by a partnership agreement and common law. On the other hand, the most common structure for the formation of private equity funds in England and Wales is an English Limited Partnership (Figure 2), which is established under the Limited Partnerships Act 1907 of the UK.[287] The Limited Partnerships Act regulates a number of issues that arise in the financial activities of private equity funds. Similarly, limited partnerships are commonly established in Scotland and Northern Ireland which are also governed by the Limited Partnerships Act. Under Scottish law limited partnerships have a 'separate legal personality and are commonly used for feeder partnerships or as funds of funds but under English law a limited partnership is not a separate legal entity.'[288] The Limited Partnerships in UK allow profits to be distributed to investors as capital rather than as income profits.[289] The South African *en commandite* partnerships are akin to the Limited Partnership legal structures and both structures are suited to an illiquid asset class such as PEIs that generally has few redemption rights.

286 Cassim FHI et al *The Law Of Business Structure* (2012)18.

287 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

288 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

289 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

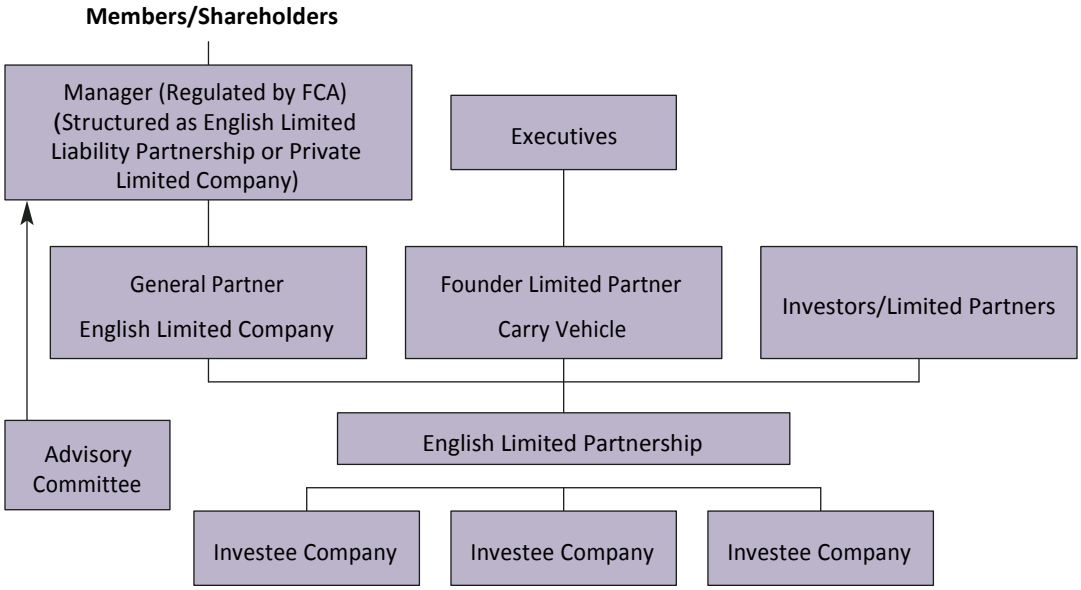

Figure 2: Structure of private equity investment in the United Kingdom

Source: British Venture Capital Association

In contrast to the *en commandite* partnerships in SA, Limited Partnerships in England and Wales are registered with the Registrar of Limited Partnerships[290] at Companies House. The Registrar of Limited Partnerships in the Companies House is the same person as the Registrar of Companies. For as long as a Limited Partnership is not registered in the UK, it remains a general partnership.[291] Companies House issues a certificate of registration after a registration statement has been signed by both general and limited[292] partners and lodged with the Registrar. A Limited Partnership in the UK is required to submit details of the names of each and every LP as well as their capital contributions and the information is publicly available at the Companies House.[293] The requirement for all LPs to be registered is very useful in the regulation of PEIs in the UK. On the contrary, in SA, the e*n commandite* partnership legal structure does not disclose the names of the undisclosed LP. However, the UK authorities maintain that the number and identity of LPs becomes relevant when LPs fail to comply with any requirements necessary to preserve their limited liability status. The identity of a LP is considered of relevance if the LP participates

290 Section 15 Limited Partnerships Act 1907.
291 Section 5 Limited Partnerships Act of 1907.
292 Section 8 Limited Partnerships Act of 1907.
293 Sections 3, 8 and 9 Limited Partnerships Act 1907.

in the 'management of the Limited Partnership' and thereby losing the limited liability status.[294] Although the Limited Partnerships Act does not define what constitutes 'management' for this purpose, it is generally accepted that a LP is not taking part in the management when the LP behaves within the rights under a partnership agreement. [295] In SA, the methods used for monitoring LPs so that they do not incur personal liability for the debts of the *en commandite* partnerships, are generally regarded as comparatively 'simple and unsophisticated'.[296] The South African FSB has not issued a list of permitted activities for LPs in PEIs as is the case in a number of countries, and as a result LPs adopt a 'conservative and entirely passive approach' to PEIs operations and activities.[297] The Limited Partnerships Act in the UK provides for another circumstance a LP may partially lose unlimited liability status. When a partner withdraws capital while he remains a member of the fund it 'renders him liable for the debts and obligations of the firm up to the amount which he has received back'.[298] In other words, under English law, if the capital of a limited partnership is returned to investors before the partnership has been wound up, then the investors would lose their unlimited liability status to the extent of the capital that has been returned. To this end, the Limited Partnerships Act stipulates that an investor's capital may not be returned prior to the termination of the LP.

Just like in the South African law, the Limited Partnerships Act provides for a body corporate to be an LP. It however, 'does not provide for body corporate being a GP.'[299] Another similarity is that in both the UK and in SA the limited partnership agreement states the duties or responsibilities of the partners. However, the Limited Partnerships Act in the UK further provides for the 'rights and obligations of the partners' and requires that all LPs be treated equally. It also provides that it is a statutory right of LPs to check the records of the partnership and consult with the GP on the plans and objectives of the Limited Partnership.[300] On the other hand, in the South African regulatory framework, the partners of the private equity fund acting through the *en commandite* partnership's GP are usually advised by an adviser that interacts

294 Section 6 (1) Limited Partnerships Act of 1907.
295 Section 6 Limited Partnerships Act of 1907.
296 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).
297 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).
298 Section 4 (3) Limited Partnerships Act of 1907.
299 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).
300 Section 6 (1) Limited Partnerships Act of 1907.

closely with the private equity firm. 'Individual investors may also individually negotiate side letter terms with the fund or its' adviser and after that it is obscure whether the side letter terms allow the partners to be treated equally. [301]

Normally a limited partnership agreement states that, upon bankruptcy or insolvency of the GP, a specified majority of LPs can elect whether or not to continue the limited partnership with a new GP. In contrast, the Limited Partnership Act provides that a partnership may not end because of 'the death or bankruptcy of a LP.'[302] Since the Limited Partnership Act does not provide that the bankruptcy or insolvency of the GP results in the spontaneous dissolution of the partnership, the terms of the LP agreement are determinative.[303] *En commandite* partnership agreements in SA provide for the removal and replacement of the GP in terms of common law legal requirements. Such removal and replacement would normally require the consent of all the creditors of the *en commandite* partnership.

A striking difference between PEIs in the UK and those in SA is that in the UK various PEIs firms trade on the London Stock Exchange, including 'venture capital funds, buyout funds, development capital funds, turnaround/restructuring funds, general funds, and funds of funds.'[304] These private equity funds are typically structured as offshore companies that are 'listed on the London Stock Exchange's main market, the Alternative Investment Market (AIM) or the Specialist Fund Market (SFM).'[305] The SFM was formed in 2007 as a market intended to attract sophisticated investors and limited partnerships are also eligible to be listed on the SFM. In SA, public companies are bought and sold on the JSE but private firms such as PEIs are not. The end result of this is that public companies are highly liquid, tradable daily and settlement is certain through a regulated stock exchange. Conversely, private companies are difficult to trade as any transaction must be negotiated directly between the buyer and seller. The key benefits of listing PEIs is 'increased liquidity for investors as they are able to trade their interests on the listed

301 Loubser J, Viviers J & Minnaar A 'The private equity review' available at *http://www.ens.co.za/news/news_article.aspx?iID=1024&iType=4* (accessed 8 November 2015).

302 Section 4 (2) Limited Partnerships Act of 1907.

303 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

304 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

305 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

market, and the fund would have access to investors who prefer to, or are required to, invest only in listed securities.'[306]

As pointed out earlier, the fund managers of PEIs in the UK are authorised by the FCA and PRA before carrying out regulated activities. However, there are other subordinate regulatory measures such as the Criminal Justice Act, 1993 (the CJA), the EU's Alternative Investment Fund Managers Directive 2011/61/EU (AIFM Directive), the Bribery Act 2010, the Companies Act 2006, and The Walker Guidelines, which support the FCA so as to make the regulatory framework of PEIs comprehensive. Regulation of PEIs in the UK is discussed in the next few sections in such a way as to emphasise the differences with PEIs' regulation in SA. At the end a summary of similarities between regulation of PEIs in the UK and SA is provided.

4.2.2 The Financial Conduct Authority (FCA)

Similar to SA's FSB, the FCA is also a fund manager level focused authority. In addition to promoters and fund managers, the FCA also requires any 'employees or officers of authorised firms that carry out key functions in a fund to be individually authorised by the FCA.'[307] Private equity fund managers in SA 'may not act or offer to act as financial services providers unless' they are approved by the Registrar of Financial Services and have the required licence under the FAIS Act.[308] As discussed in Chapter 2, the FSB also does not directly regulate the private equity funds in SA. The growing influence of EU legislation and standards on UK policy-making and supervisory practices has resulted in the FCA incorporating the EU and international requirements. For that reason, in terms of regulating private equity funds, the FCA has a much broader regulatory framework than the FSB in SA.

There is an inherent risk posed to LPs by investments due to factors, such as, the complexity of the financial products, lock ins and carried interest or financial charges by the fund managers. Therefore the British government allows the FCA to intervene and instruct a financial service

306 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

307 The Financial Conduct Authority '*Approach to regulation'* (2011) available at *www.fsa.gov.uk/fca* (accessed 18 February 2015).

308 Section 4 (2) FAIS Act 37 of 2002.

provider to remove or correct 'misleading financial promotions,'[309] and 'to publish a warning notice'[310] with regards to a financial product identified. Through a new approach, called product intervention, the FCA can intervene earlier in the product life cycle, inspecting products and requiring firms to have in place efficient structures or completely eliminate the financial product.

One of the objectives of the FCA is to be proactive in regulating PEIs and hedge funds that may pose a risk to the financial markets. It builds on the risks PEIs pose to the economy as outlined and categorised in a discussion paper by the FSA in 2006. The FCA aims for early detection and deterrence of risky conduct in order to protect clients as well as maintain the integrity of markets and competitive edge.[311] The FCA also has the power to investigate firms and individuals which enhances its credible deterrence strategy[312] and firms are continuously subject to the requirements in the FCA Handbook of Rules and Guidance.

4.2.3 Criminal Justice Act, 1993 (the CJA)

Within the CJA is a regime that deals with insider trading which affects PEIs normally in the exit stage or IPOs. The CJA Part V seeks to 'i) prevent individuals from dealing in price affected securities on the basis of insider information (ii) prohibit one to encourage another to deal in price affected securities on the basis of insider information and iii) prohibit disclosure of insider information to another.'[313] The insider trading offence in the UK can lead to a sentence of up to seven years or a fine.

The South African law also recognises the conflict of interest in funds that trade on financial markets and take part in PEIs activities. The provisions of The FMA[314] of SA apply to individuals, partnerships, trusts and juristic persons while, in contrast, the English CJA applies to

309 Section 388 FSMA 2000.
310 Section 387 FSMA 2000.
311 The Financial Conduct Authority '*Approach to regulation'* (2011) available at www.fsa.gov.uk/fca (accessed 18 February 2015).
312 The Financial Conduct Authority '*Approach to regulation'* (2011) available at www.fsa.gov.uk/fca (accessed 18 February 2015).
313 Criminal Justice Act of 1993.
314 Act 19 of 2012.

individuals and has not been extended to juristic persons.[315] Another provision of the FMA in SA that makes it effective in curbing insider trading is the exclusion of international theories, such as, Chinese Walls. The theory of a Chinese Wall 'seeks to protect juristic persons from incurring liability for insider trading due to inside knowledge of their employees being attributed to them in law.'[316] The FMA, by not introducing Chinese Walls as a formal legal defence, has made it mandatory for all juristic persons, including trusts and partnerships, to make full and prompt disclosure of all material corporate information.[317] The FMA also goes a step further than legislation in other jurisdictions, such as, the English CJA, by making 'discouraging another person to deal' an offence while under the CJA it does not constitute an offence.[318]

Under the CJA in the UK for an offence to be committed a territorial link must be established with the UK. In order for the dealing offence to be committed the individual must be physically present in the UK at the time that the act forming the deal 'or the regulated market on which the dealing occurs must be in the UK[319] or the professional intermediary with or through whom the offence was committed must be in the UK at the time.'[320] The FMA of SA permits the FSB to pursue, investigate and prosecute persons who commit the offence of insider trading while based in a foreign country and on a foreign market.[321] However, this provision is perceived to have overstretched SA's regulatory ambit and the cost of pursuing prosecutions on a global scale is viewed as prohibitive. The timeous enforcement and recognition of foreign judgements in cross-border market abuse that occurs in foreign markets is also seen as a challenge. [322]

In contrast to the English CJA which regulates, inter alia, insider trading in the UK and imposes criminal liability only, the FMA in SA also imposes statutory civil liability for insider trading. Furthermore, SA 'was the first country to initiate civil prosecution of insider trading with the

315 Richard Jooste 'Insider dealing in South Africa' (1990) 107 *SALJ* 589.
316 *Harrods Ltd v Lemon* [1931] 2 KB 157 (CA).
317 Cassim R 'Some aspects of insider trading- has the Securities Services Act 36 of 2004 gone too far?' (2007) 19 *SA Merc LJ* 57.
318 Cassim R 'Some aspects of insider trading- has the Securities Services Act 36 of 2004 gone too far?' (2007) 19 *SA Merc LJ* 57.
319 Section 62 (2) of the CJA.
320 Section 62 (1) of the CJA.
321 Cassim R 'Some aspects of insider trading- has the Securities Services Act 36 of 2004 gone too far?' (2007) 19 *SA Merc LJ* 57.
322 Chitimira H 'A historical overview of the regulation of market abuse under the Securities Services Act 36 of 2004' (2014) 47 *De Jure* 2 310- 328.

added advantage of compensation for those prejudiced by insider trading.'[323] In comparison, a small number of cases in jurisdictions, such as, the US and the UK, that are amongst the leaders in insider trading legislation, have been referred for criminal prosecution.[324] The civil penalties can be the equivalent of the profit made from such a transaction and are in the form of 'a penalty of up to R1 million plus three times the profit made, with interest, and the cost of such a lawsuit.'[325] In response to various listed instruments that trade globally, the FSB has agreements on insider trading and market abuse 'with the FCA in the UK and the Securities Exchange Commission in the US.'[326] Civil liability in SA under the FMA and its predecessors has been more effective in reducing insider trading in SA, showing that South African law is amongst the most effective and unprejudiced regimes in the world.[327]

4.2.4 The EU Directive on Alternative Investment Fund Managers (AIFM Directive)

The regulation of PEIs in the UK now conforms to the regional regulatory framework through the EU's AIFM Directive that emanated from the lessons learnt during the financial crisis of 2008/9[328] and was transposed into UK law in 2013.[329] The AIFM Directive was developed in response to international pressure for the regulation of PEIs, in spite of the objections from the BVCA that this would negatively impact the industry.[330] Private equity fund managers in the UK now need the FCA's approval for any operations that are within the AIFM Directive framework. The AIFM Directive is aimed at extending the rules that oversee banks and investment firms to PEIs. It seeks to harmonise the EU-wide regulatory regime for managers of PEIs and impacts on many of the duties and activities of managers as regards EU based funds. This has led to increased regulation related to marketing of PEIs in the region, with stricter laws on risk control and prescribed ranges of GP's remuneration and bonuses.

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323 *JSE Insider Trading Booklet* (2013) 4.
324 *JSE Insider Trading Booklet* (2013) 4.
325 Section 82 Financial Markets Act 19 of 2012.
326 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).
327 Richard Jooste 'Insider dealing in South Africa' (1990) 107 *SALJ* 589.
328 Onions A et al 'Private equity and venture capital' (2014) available at *http://uk.practicallaw.com/topic0-103-1350* (accessed 12 January 2015).
329 Onions A et al 'Private equity and venture capital' (2014) available at *http://uk.practicallaw.com/topic0-103-1350* (accessed 12 January 2015).
330 Onions A et al 'Private equity and venture capital' (2014) available at *http://uk.practicallaw.com/topic0-103-1350* (accessed 12 January 2015).

An essential requirement transposed by the AIFM Directive is that PEIs are required to increase transparency with regards to investee firms. The portfolio companies held by private equity funds are usually private investments and are therefore not governed by the strict requirements of disclosure and transparency. However, the AIFM Directive requires 'transparency with regards to employees, business strategies, setting up of time-limited precautions against the loss of capital and makes proposals for managing conflicts in portfolio companies.'[331] The AIFM Directive also requires EU based funds, or funds promoted in the EU, to monitor cash flows and supervise the fund manager's activities.[332]

These requirements make the EU reporting requirements different from SA, 'because the AIFM Directive is based on a binding legal requirement, not on voluntary disclosure' or a partnership agreement between a GP and investors/funds.[333] South African PEIs are not regulated by a specific regional framework. However, the South African 'FSB has entered into co-operation agreements with a number of EU member states under the auspices of the AIFM Directive.'[334]

4.2.5 The Bribery Act 2010

The Bribery Act of 2010 in the UK is among the strictest legislation on bribery internationally and introduces a strict liability offence against both companies and partnerships for failing to prevent bribery. The Bribery Act seeks to address the requirements of the 1997 OECD Anti-Bribery Convention. It makes it an offence for a firm 'to be covering an offering, promising an advantage, giving an advantage, and requesting an advantage,[335] and agreeing to receive or

331 European Corporate Governance Institute *The Regulation Of Hedge Funds And Private Equity: A Case Study In The Development Of The EU's Regulatory Response To The Financial Crisis Working Paper N°.176/2011* (2011) available at http://stefanopagliari.net/helleiner_and_pagliari_--2.pdf (accessed 24 February 2015).

332 European Corporate Governance Institute *The Regulation Of Hedge Funds And Private Equity: A Case Study In The Development Of The EU's Regulatory Response To The Financial Crisis Working Paper N°.176/2011(2011)* available at http://stefanopagliari.net/helleiner_and_pagliari_--2.pdf (accessed 24 February 2015).

333 Cumming D & Walz U 'Private equity returns and disclosure around the world' (2010) 41 *Journal of International Business Studies* 730.

334 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at http://uk.practicallaw.com/4-376-4687 (accessed 3 January 2015).

335 Section 1 The Bribery Act 2010.

accept an advantage'.[336] The Bribery Act makes it an offence for partnerships and companies to pay or receive bribes and extends the offence to the bribing of foreign public officials.

Unlike previous legislation, the Bribery Act places strict liability upon a limited partnership for failure to prevent bribes being given. An entity can be liable for the actions of an associated person.[337] Nevertheless, the Act provides that should an offence be committed, it will be a 'defence that the company had adequate procedures in place to attempt to prevent' persons associated with the fund from undertaking bribery or to prevent bribery.'[338] This entails that the corporate responsibility is no longer dependent on the position of the employee who commits the offence but the entire corporate culture.[339] The Act can impose 'imprisonment and potentially unlimited fines.'[340]

The Bribery Act is of great relevance to the PEIs market as there is a high chance for leakage of information or bribery in the industry due to various individuals who participate in private equity deals. The definition of what constitutes a bribe is sufficiently wide as to cover political contributions in certain circumstances. The Bribery Act requires private equity firms to also consider their entertainment programs for investors, in particular foreign public officials, such as, officers at sovereign wealth funds.[341] This is particularly important in cases of offshore investments that are located in areas with high risk of corruption.[342]

Similarly, SA has a consolidated strong, legislative framework which seeks to combat bribery and corruption. The aspects of bribery and corruption are found in the Prevention and Combating of Corrupt Activities Act,[343] the Financial Intelligence Centre Act,[344] the Companies Act[345] and the King lll Report. The Corruption Act seeks to eliminate corruption and the Act provides for

336 Section 2 The Bribery Act 2010.
337 Section 7 The Bribery Act 2010.
338 Section 7 The Bribery Act 2010.
339 Nwafor AO 'Corporate criminal responsibility: a comparative analysis' (2013) 57 *Journal of African Law* 106.
340 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).
341 Section 6 The Bribery Act 2010.
342 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).
343 Act 12 of 2004.
344 Act 38 of 2001.
345 Act 71 of 2008.

'specific offences such as the accessory offence and inducing offence.'[346] The challenge may be in the enforcement system. The major differences of the corruption and bribery regulatory framework in SA with that in the UK is that the UK Bribery Act consolidates all of these aspects, presents them in an understandable way and also makes it an offence if companies fail to put in place adequate prevention procedures that are proportionate to the bribery risks that the PEI faces. In addition, the Bribery Act encourages the private sector to establish bribery prevention policies as part of good corporate governance and the Act has an extra -territorial application.[347]

4.2.6 The UK Companies Act 2006

The principal duty of the GP is to manage the activities of the private equity funds. The contracts between the GP and LPs made in the UK and SA have to be clear on the concept of 'gross negligence' as distinct from 'ordinary negligence' due to the differences in how the two jurisdictions recognise the two. In both countries individual partners cannot limit personal liability for negligence where the risks are felt to be excessive. Generally the English law recognises the concept of 'negligence' but it has no concept of 'gross negligence' as distinct from 'ordinary negligence'. In the event of a dispute it is the intentions and also the high level of neglect or indifference to potential risk that are analysed. The principal of 'gross negligence' in English law is not defined and 'gross negligence is interpreted by the English courts on a case by case basis, with reference to the wording and context' of the entire limited partnership agreement.[348] English courts have on several cases been required to interpret limited partnership contracts that include the phrase 'gross negligence.'

On the other hand, the South African law provides for 'gross negligence'. The South African Companies Act provides that 'a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person, or for any fraudulent purpose.'[349] The private equity environment in SA currently tends to exempt the GP from all other liability except for

346 Section 3 Prevention and Combating of Corrupt Activities Act 12 of 2004.
347 Section 12 (5) The Bribery Act 2010.
348 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).
349 Section 22 (1) Companies Act 71 of 2008.

'gross negligence, criminal conduct and material breach of the partnership agreement'.[350] In both jurisdictions, risk avoidance is often required to be exercised when drafting limited partnership agreements in order for the GPs to get clarity on their duties and responsibilities. The contracts between the GP and LP would also clearly guide the courts on what constitutes 'gross negligence'.

4.2.7 The Walker Guidelines

The South African private equity industry through the Private Equity Survey annual reports published by KPMG and SAVCA seeks to show its commitment to financial transparency and provides data to support the industry's contribution to the South African economy. The Private Equity Survey gives an overview or summary of the performance and structure of PEIs in SA. In the UK authorities have gone a step further by requiring individual portfolio companies to also publish annual reports of their financial performance. This was in response to the increased examination and negative publicity the private equity industry encountered in 2007 from the media, trade unions and politicians which resulted in the Treasury Select Committee hearings. Sir David Walker published a set of guidelines at the request of the BVCA that require greater transparency and disclosure within the private equity industry and their investee companies.[351] The Walker Guidelines and the supporting Guidelines Monitoring Group (GMG) 'provide a set of self-regulatory rules, and establish oversight and disclosure comparable to those faced by companies on the FTSE 350 stock exchange.'[352]

The EU's AIFM Directive is legally binding but the Walker Guidelines operate on a 'comply or explain' basis and are applicable to large entities, with any non-compliance being required to be explained on the company's website.[353] The Walker Guidelines also prescribes that portfolio company reports 'should focus on substance rather than form, that is, the economic reality of

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350 Khoza F 'Retirement funds in private equity funds: some issues to consider' available at *http://www.bowman.co.za/News-Blog/Blog/retirement-funds-investment-private-equity-funds* (accessed 28 December 2014).

351 British Private Equity and Venture Capital Association 'Private equity explained' available at *http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx* (accessed 10 January 2015).

352 British Private Equity and Venture Capital Association 'Private equity explained' available at *http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx* (accessed 10 January 2015).

353 Addleshaw Goddard 'The Walker Guidelines for disclosure and transparency in private equity' available at *http://www.addleshawgoddard.com/asset_store/document/walker_guidelines_-_checklist_95735.pdf* (accessed 25 February 2015).

limited partnerships rather than its legal values.'[354] According to the Walker Guidelines portfolio companies are required to publish financial statements and annual reports on their websites within a period of six months after the annual shut down.[355] During the year, investee companies are also required to publish within three months after mid-year, a mid-year report that does not include accounting records but describes the progress made to that point.[356] In addition, the Walker Guidelines requires a 'business review that substantially conforms to the expanded disclosure obligations applicable to quoted companies under section 417 (5) of the Companies Act.'[357] In SA only public companies are required to publish annual reports publicly. Private companies are not compelled to do so and this makes it difficult for potential investors to obtain financial information on some private companies. Self-regulation of the private equity industry has not yet developed to the levels the UK has reached.

4.3 SIMILARITIES BETWEEN THE UNITED KINGDOM AND SOUTH AFRICA IN THE REGULATION OF PRIVATE EQUITY INVESTMENTS

The main similarities exist in the regulations related to money laundering and takeovers and mergers as outlined below.

4.3.1 The Money Laundering Regulations 2007

Money laundering 'is the process by which the proceeds of crime are converted into assets which appear to have a legitimate origin.'[358] PEIs in the UK are required to 'establish and maintain effective systems and controls that enable them, among other things, to recognise, assess, and control the risk of money laundering' or terrorist financing.[359] Similarly, GPs of hedge funds and

354 British Private Equity and Venture Capital Association 'Private equity explained' available at http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx (accessed 10 January 2015).

355 Addleshaw Goddard 'The Walker Guidelines for disclosure and transparency in private equity' available at http://www.addleshawgoddard.com/asset_store/document/walker_guidelines_-_checklist_95735.pdf (accessed 25 February 2015).

356 Addleshaw Goddard 'The Walker Guidelines for disclosure and transparency in private equity' available at http://www.addleshawgoddard.com/asset_store/document/walker_guidelines_-_checklist_95735.pdf (accessed 25 February 2015).

357 Addleshaw Goddard 'The Walker Guidelines for disclosure and transparency in private equity' available at http://www.addleshawgoddard.com/asset_store/document/walker_guidelines_-_checklist_95735.pdf (accessed 25 February 2015).

358 The Money Laundering Regulations 2007.

359 Davids E & Hale A *Mergers and acquisitions review* (2012) available at `

PEIs in SA are subject to the Financial Intelligence Centre Act[360] which monitors the recognition of earnings from illegitimate operations as well as methods of eliminating money laundering. Private equity funds in SA are required to adhere to anti-money laundering requirements by monitoring investor activities and establishing internal procedures to train staff to guard against money laundering.'[361] They are also required to report any indication of money laundering to the applicable authorities.

The GPs of the Limited Partnerships in the UK are required to follow the rules and regulations of the FCA on money laundering, and also the obligations set out in other statutes, including the Terrorism Act 2000, the Proceeds of Crime Act 2002 and the Money Laundering Regulations 2007. The Money Laundering Regulations in the UK requires private equity funds to nominate an officer who receives internal reports with regards to any knowledge or suspicion of money laundering structures to eradicate potential money laundering or terrorist financing activities.[362] PEI firms in the UK are required to prepare reports that cover record keeping, risk assessment, compliance communication and management of money laundering policies.[363]

4.3.2 City Code on Takeovers and Mergers

Private equity dealings, such as, buyouts, IPOs and takeovers are generally subject to strict regulations as they are considered risky financial transactions.[364] Generally, buyouts of listed companies by private equity funds in SA are not common.[365] In the UK the acquisition of a publicly listed companies is regulated by the 'City Code on Takeovers and Mergers (the Code), the Companies Act 2006, the Financial Services & Markets Act 2000, the Model Code on

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http://www.bowman.co.za/FileBrowser/ArticleDocuments/MergersandAcquisitionsReview-4thEdition- SouthAfrica.pdf (accessed 10 January 2015).

360 Act 38 of 2001.

361 Financial Intelligence Centre Act 38 of 2001.

362 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

363 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

364 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

365 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' (2014) available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

Directors' Dealings, the Listing Rules and the Criminal Justice Act 1993.'[366] The takeover regulations provided for in the Companies Act[367] of SA as discussed in Chapter 3, are mainly influenced by the Code of the UK.[368] The Code aims to ensure that takeovers are carried out in a well organised and regulated environment. It mainly ensures that there is fair treatment and well informed decision making by the shareholders of the offeree company involved in a takeover.[369] In sum, the Code seeks to uphold, together with other statutes and supervisory establishments, the stability of the capital markets.

4.4 CONCLUSION

The purpose of this chapter was to compare the regulation of PEIs in SA with one of the leading global jurisdictions in relation to private equity, namely, the UK and draw lessons from it. As a result of SA's history, there are generally a number of similarities in its regulation of PEIs and the regulations provided by English law. The fields of South African company law and insolvency have also been influenced by English law.[370] However, the South African law is mainly based on the Roman-Dutch Law and has continued to develop through new legislation and the influence of court decisions. Therefore there are also various striking contrasts between the private equity regulatory system of the UK and the corresponding South African system.

As outlined above, the most common legal structure in the UK is mainly governed by the consolidated and comprehensive Limited Partnerships Act. On the contrary, *en commandite* partnerships in SA are mainly governed by common law. In addition, through the UK's main regulatory body, the FCA, there is a shift towards a proactive, risk management approach through early intervention and enforcement to avoid offences. There are also evolving statutory reforms that show that a fault element should prove that the fund did not set and monitor a

366 Barry B 'Getting the deal through – private equity England and Wales' (2011) available at *www.gettingthedealthrough.com* (accessed 10 January 2015).

367 Act 71 of 2008.

368 Davids E & Hale A *Mergers and acquisitions review* (2012) available at *http://www.bowman.co.za/FileBrowser/ArticleDocuments/MergersandAcquisitionsReview-4thEdition-SouthAfrica.pdf* (accessed 10 January 2015).

369 Davids E & Hale A *Mergers and acquisitions review* (2012) available at *http://www.bowman.co.za/FileBrowser/ArticleDocuments/MergersandAcquisitionsReview-4thEdition-SouthAfrica.pdf* (accessed 10 January 2015).

370 Geach W & Yeats J *Trusts* (2007) 11.

business culture that ensures the identified offence is not committed.[371] For instance, under the Bribery Act, a fund is liable unless it is possible to show that sufficient policies and measures to deter such offences. Generally, the UK regulatory framework, through the EU's Directive 2011/61/EU and the Walker Guidelines places a strong emphasis on disclosure and transparency by requiring funds to demonstrate their business integrity through the publication of their annual reports. The regulatory requirements have been refined such that the AIFM Directive aims at extending the stringent rules that regulate banks and investment companies to hedge funds and PEIs. Another striking contrast between the UK and SA, which was discussed in Chapter 3, is the B-BBEE. The South African government and other development agencies recognise the private equity asset class as one of the effective vehicles for addressing economic transformation and inequalities. The UK does not have legislation that is similar to B-BBEE Act.

Although there are major differences between PEIs' regulation in SA and that of the UK, a number of noteworthy similarities exist in the two jurisdictions. Both jurisdictions have legislation that targets corruption, insider trading and money laundering. In addition, the South African regulation of takeovers and mergers is mainly influenced by the City Code on Takeovers and Mergers of the UK.

Apart from having a consolidated legislation regulating PEIs, generally, there has been an expansion in the scope of the regulation of PEIs in the UK to include more co-regulation and regional requirements to the traditional, conservative common law. For example, the UK regulatory framework now includes the EU's AIFM Directive and the Walker Guidelines. This integration of regional requirements has helped the UK to open up new markets in the region. The UK regulatory framework also now has a number of requirements regarding strategic deterrence, disclosure and transparency, three factors that are very important in attracting and retaining investors. This could partly be the reason why the UK remains globally competitive and continues to attract more investors than the South African private equity market. Therefore, there are regulatory initiatives in the governance of PEIs in the UK that can be recommended so as to improve the regulation of PEIs in SA. These lessons will be further highlighted in the

371 Nwafor AO 'Corporate criminal responsibility: a comparative analysis' (2013) 57 *Journal of African Law* 97.

recommendations discussed in Chapter 6. The next chapter discusses the implications of the South African regulatory system on the private equity industry.

CHAPTER 5

IMPLICATIONS OF FINANCIAL REGULATION IN SOUTH AFRICA ON PRIVATE EQUITY INVESTMENTS

5.1 INTRODUCTION

During the past decade, and notably between 2007 and 2012, PEIs in SA slackened in the value and amount of deals. One of the major reasons that has been linked to this low performance was the higher cost of debt.[372] Although market forces have always been regarded as the ultimate regulators of PEIs internationally, there has also been a concern about the private equity environment being marred by increased risk. The risk has come from 'overleveraged transactions, an increase in potential costs to investors from insider trading, price fixing'[373] and in general a lack of or limited transparency regarding PEI transactions. As a result the regulatory environment has also, it has been proposed, affected the attractiveness of the private equity industry since the legal system is an essential factor in the attracting or investing funds. The trend, particularly by the G20, IOSCO, the EU and the UK regulatory framework, has moved towards regulating PEIs and the fund managers.[374] This chapter discusses the implications of the current regulatory factors on private equity performance in SA. These implications together with the UK regulatory regime will guide the recommendations for improvement which will be discussed in the next chapter.

The implications discussed here have been identified mainly in the FAIS Act, B-BBEE Act and *en commandite* partnerships.

5.2 Financial Advisory and Intermediary Services Act (FAIS Act) 37 of 2002

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372 Davids E & Hale A *Mergers and Acquisitions Review* (2012) 4.

373 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

374 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag Gov* 200.

The conduct of private equity fund managers in SA is regulated through the FAIS Act.[375] PEIs fund managers are, broadly speaking required to register as financial services providers under the FAIS Act. However, the regulation of PEI managers does not amount to the regulation of the fund itself. Current trends show that the underlying risks in PEIs are not limited to the private equity fund managers only. 'Leveraged finance providers, transaction advisers, investors, portfolio companies as well as the relevant equity, debt and related derivative products' also pose risk to some degree.[376] In addition allowing the private equity funds to regulate themselves results in complex conflicts of interests, which could negatively affect investor confidence.[377] Although industry standards address a number of abuses, the process of allocating funds to various investments, participating in different stages of 'proprietary and advisory activities, and taking up more than one role in a single transaction' can undermine self-regulation.[378] Ensuring compliance to industry regulations can be challenging especially on issues of conflicts of interest.

In addition, PEIs use considerable amounts of debt in their operations and can consequently pose a systematic risk to the financial sector. The global financial meltdown showed that 'individual financial institutions can be a source of systemic risk to financial stability because of their size, complexity, interconnectedness and provision of essential services and infrastructure.'[379] The risk that private equity funds pose is widespread and leaving funds to regulate themselves may discourage risk-averse investors. Another factor which may discourage investment in SA is that of limited transparency such as that prescribed in the EU's legally binding AIFM Directive. Providing funding to another private equity firm which operates in an unregulated private equity territory, such as SA, may present a higher risk than a similar business which operates out of one well-regulated territory. The AIFM Directive further provides for the disclosures by portfolio companies to investors and to the Registrar of Companies. This type of transparency is yet to be transposed in the South African law.

375 Ritchie LS *The Private Equity Review* 3 ed (2014) 11.

376 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

377 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag Gov* 226.

378 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag Gov* 226.

379 Davis K 'Regulatory Reform Post the Global Financial Crisis: An overview' available at *http://www.apec.org.au/docs/11_CON_GFC/Regulatory%20Reform%20Post%20GFC-%20Overview%20Paper.pdf* (accessed 28 February 2014).

During the course of turning around investee companies GPs report to LPs the value of portfolio companies and that of unrealised investments.[380] However, the valuations of these illiquid assets is difficult as well as subject to discretion as funds are not required by law to disclose this. 'Internal rates of return (IRR) can be calculated on a number of assumptions but the assumptions made make a' big difference to the results. It is 'rare for two firms to calculate IRR in exactly the same way.'[381] While a standardised system of valuation is yet to be set internationally, the Registrar of Pension Funds has prescribed the use of International Private Equity and Venture Capital Valuation Guidelines[382] (these Guidelines have been adopted by over 25 countries globally).[383] The use of PEIs valuations in an economy is widespread and having a standard method of valuing PEIs that is enforced by law would allow investors to make clear comparisons of investment options. This would particularly apply to offshore or regional investments to reduce any distortions in the allocation of capital across countries. Unless this is addressed, it is likely that some investors may not include PEIs among investment options, which might be contributing to the sub-optimal performance of the economy.[384]

5.3 The Broad-Based Black Economic Empowerment Act (B-BBEE Act) of 2003

One of the main influential regulative instruments of private equity investments is the B-BBEE Act.[385] The major feature of the B-BBEE framework has been the provision for equity ownership by Blacks. Consequently, a number of South African firms 'concluded transactions in which they disposed of a significant equity stake, generally up to 25.1 per cent, to Black shareholders.'[386] The sector and generic Codes of Good Practice have brought significant changes to the PEI industry.[387] The Codes give a better B- BBEE rating to portfolio companies whose shares are held by private equity funds that are owned by Black managers.[388] The total number of points

380 Cumming D & Walz U 'Private equity returns and disclosure around the world' (2010) 41 *Journal of International Business Studies* 730.
381 Cumming D & Walz U 'Private equity returns and disclosure around the world' (2010) 41 *Journal of International Business Studies* 730.
382 Condition 8 Regulation 28.
383 Section 5(2) (e) Pension Funds Act 24 of 1956.
384 Cumming D & Walz U 'Private equity returns and disclosure around the world' (2010) 41 *Journal of International Business Studies* 730.
385 The Broad-Based Black Economic Empowerment Act 2003.
386 Davids E & Hale A *Mergers and Acquisitions Review* (2012) 4.
387 Paragraph 5 the BEE Codes 26.
388 Bowman Gilfillan *Private equity Africa yearbook 2013/14 2* ed (2014) 24.

has been increased with effect from 1 May 2015 making it more difficult for portfolio companies to 'achieve level four to level one BEE status.'[389] The clarifications in the generic Codes of Good Practice that came into effect on 1 May 2015 also tackle the issue of fronting practices which had become an obstacle in effectively implementing B-BBEE in PEIs. The effectiveness of these amendments remains to be seen.

Critics of the B-BBEE Act argue that the Act has an unfair emphasis on race rather than merit, qualifications and experience.[390] In 2010, Pravin Gordhan, the then Minister of Finance, said: 'BEE policies have not worked and have not made South Africa a fairer or more prosperous country.'[391] In a newspaper commentary by William Gumede,[392] translated from Afrikaans, his closing remarks were that 'South Africa will never reach its full potential if we do not cultivate a system based on merit.' Considering that the survival of private equity depends on investment acumen, such concerns, when not fully addressed can negatively affect investor confidence and may contribute to reduced foreign PEI activity. It could also be for this reason that, given the perceived, unique risk profile of PEIs and the B-BBEE concerns, the borrowings made for B-BBEE 'transactions tend to attract particularly high interest rates.'[393] In the statistical results of the survey by Professor Kruger, respondents did not think that BEE positively impacts their 'companies' performance, overall international competitiveness, financial performance, business ethics or transparency.'[394] In addition the regulation is viewed as falling short of building competitiveness due to both the flight and unemployment of essential, skilled workers. Therefore, there is need not only to close loopholes and avoid creating more economic imbalances through the B-BBEE Act, but also to incentivise effective Black investment without compromising investor confidence.

5.4 *En commandite* partnerships

389 Werksmans Attorneys 'Amendments to the BBBEE Act and the Codes explained' (2014) available at *http://www.werksmans.com/wp-content/uploads/2014/11/041763-WERKSMANS-bbbee-booklet.pdf* (accessed 17 May 2015).

390 Krüger LP 'The impact of black economic empowerment (BEE) on South African businesses: focusing on ten dimensions of business performance' (2011) 15(1) *Southern African Business Review* 207.

391 Jeffery A 'BEE is flawed and should be scrapped' *Mail and Guardian* 18 January 2013.

392 Gumede W 'Scrap BEE, follow merit for a strong SA' *Rapport, Weekliks* 26 February 2012.

393 Davids E & Hale A *Mergers and acquisitions review* (2012) available at *http://www.bowman.co.za/FileBrowser/ArticleDocuments/MergersandAcquisitionsReview-4thEdition- SouthAfrica.pdf* (accessed 10 January 2015).

394 Krüger LP 'The impact of black economic empowerment (BEE) on South African businesses: focusing on ten dimensions of business performance' (2011) 15(1) *Southern African Business Review* 207.

A partnership in SA has no separate legal existence or (in general) it has no limited liability. In a number of cases, statute has had to some extent make inroads into this general principle particularly for litigation purposes, in insolvency law, tax law and procedural law. Generally, in common law after dissolution of a partnership, a creditor may sue any individual partner for the full amount of the partnership debts.[395] However, in an *en commandite* partnership *commanditarian* partners are only liable to the extent they have contributed. A related concern on e*n commandite* partnership would involve the unclear ownership of economic risk that could create costly barriers for lenders to negotiate settlements.[396] It is possible that the excessive leverage the private equity industry needs, coupled with the obscure ownership of economic risk, could discourage risk averse lenders or lead to a high cost of debt for the industry.[397]

The UK's Limited Partnership Act provides for the rights and obligations of the partners and requires that all LPs be treated equally. However, in SA, each LP negotiates the terms of the partnership agreements. The terms may be different from those stated in the private equity fund's constitution and it becomes a challenge to keep the investors equal. In this regard, South African investors have a crucial task of exercising pre-investment and post-investment due diligence. It is essential for LPs to understand the terms they are supposed to be negotiating, and agreeing to, for them to receive the best deal.[398] LPs may consider using the general most favoured nation provision. This is a provision that 'allows the investor to take the benefit of any terms given to all investors, or to other investors who have the same amount invested in the fund.'[399] The side letter becomes crucial because it contains terms that have been granted other LPs and which may be useful to the investor. As a result in SA, LPs such as retirement funds can arrange their investments according to their own terms. Such flexibility may bring protection to other investors or alternatively make private equity prone to governance risks that my affect smaller classes of investors.

395 Cassim FHI et al *The Law Of Business Structure* (2012) 21.

396 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

397 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

398 Khoza F 'Retirement funds in privateequity funds: some issues to consider' available at *http://www.bowman.co.za/News-Blog/Blog/retirement-funds-investment-private-equity-funds* (accessed 28 December 2014).

399 Khoza F 'Retirement funds in privateequity funds: some issues to consider' available at *http://www.bowman.co.za/News-Blog/Blog/retirement-funds-investment-private-equity-funds* (accessed 28 December 2014).

In *en commandite* partnerships a LP is undisclosed and occupies the position of a partner only insofar as the co-partners are concerned, but not in regard to outsiders.[400] The requirement for all LPs to be registered and disclosed under the UK's Limited Partnerships Act is a very useful tool for the regulators to monitor ongoing activities and also ensure that LPs do not participate in the management of the fund. The FSB in SA has not issued a list of permitted LPs' activities in PEIs as in other states.[401] While the South African legal structure seeks to protect LPs, it creates an obscure system with regard to the participation of LPs in PEIs. In this regard, the laws and regulations in the UK offer more transparency.

Unlike public companies, *en commandite* partnerships do not trade on the JSE and are not registered and therefore the investors are not guaranteed of the same protection of transparency, corporate governance and accountability that is extended by the Companies Act.[402] This might negatively affect the attractiveness of the private equity industry to risk-averse investors who value clarity, transparency and disclosure. Although, the advantages of private equity funds not being listed include the lesser public disclosure and the related reduced costs, PEIs may fail to attract investors who prefer to, or are required to, invest only in listed securities[403] In the UK, various private equity funds are listed on the stock exchange and listed PEIs are deemed highly liquid and tradeable. In addition, settlement is guaranteed through the regulated stock exchange.

5.5 CONCLUSION

New investors could be attracted to the South African private equity industry by building on and enhancing the provisions of the FAIS Act. Consequently, in order for the private equity industry to remain competitive and attractive to investors, the regulatory environment in SA needs to evolve in line with international trends. The Codes of the B-BBEE Act could be fine-tuned to seal loopholes that may negatively affect investor confidence. There is room for improvement in the common law features on the structure of *en commandite* partnerships, especially with regards to issues of clarity and transparency. The listed private equity structures are generally regarded

400 Bowman Gilfillan *Private equity Africa yearbook 2013/14 2* ed (2014) 23.

401 Roderick L, Kennedy-Good S & Wellsted A 'Private equity in South Africa : market and regulatory overview' available at *http://uk.practicallaw.com/4-376-4687* (accessed 3 January 2015).

402 Companies Act 71 of 2008.

403 Financial Services Authority Discussion Paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

as being less risky as they are subject to greater regulation than unlisted companies. The foregoing discussion has shown that more could still be done to ensure the competitiveness of the private equity industry in SA. The next chapter provides some recommendations for improving PEIs performance in SA, most of which will target issues raised in this chapter.

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 CONCLUSION

The main PEIs legal structures in SA include the *bewind* trusts, *en commandite* partnerships and companies 'whose assets and liabilities are limited to the assets and liabilities arising from their private equity investments'.[404] The *en commandite* partnerships are now the major and popular structures as they are operated in accordance with global trends with regards to the regulation of the fund and limitation of the LPs' liability.[405] There is no single or specific statute regulating activities of private equity funds. On the contrary, there are separate pieces of legislation and regulatory rules[406] that include the FAIS Act,[407] the B-BBEE Act[408] and the BEE policy framework, the Companies Act,[409] the PFA,[410] the FMA,[411] the Regulations, the Competition Act,[412] the JSE Listing Requirements, and the King Reports on Corporate Governance.[413] The challenge is how to harmonise these regulatory instruments so that a consolidated framework for regulating PEIs is developed.

Internationally, PEIs are now subject to stricter standards and are developing into more transparent investments. The more dynamic jurisdictions, such as the UK, have moved from the conservative common law tradition and now include co-regulation in the regulation of PEIs. The UK has also incorporated the European Union's AIFM Directive and its regulatory framework has continued to evolve through the significant authority of the FCA with its credible deterrence

404 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at www.gettingthedeal.com (accessed 19 November 2014).
405 Bowman Gilfillan *Private equity Africa yearbook 2013/14 2*ed (2014) 23.
406 Modise L, Makola M & Van Zuylen C 'The private equity-South Africa' available at www.gettingthedeal.com (accessed 19 November 2014).
407 Act 37 of 2002.
408 Act 53 of 2003.
409 Act 71 of 2008.
410 Act 24 of 1956.
411 Act 19 of 2012.
412 Act 89 of 1998.
413 Competition Act 89 of 1998.

strategy. In addition, the co-regulatory framework of the Walker Guidelines in the UK upholds transparency and disclosure of PEIs.

Effective regulation of the private equity funds in SA can make the investments more transparent, enhance the attractiveness of the industry and ultimately facilitate the industry to contribute more to the economy. It would also protect all stakeholders of PEIs and investee companies. Strategic regulation of the funds can ensure that the asset class expands through enhanced investor confidence in the investment models, plans and services. In addition, by allowing progressive skills transfer, SA can address the previously economically disadvantaged without compromising on merit of management and ultimately investor confidence. The amended Codes of Best Practice of the B-BBEE that aim to promote black management of private equity funds through the B-BBEE Act, if not continuously monitored and effectively enforced, may create further loopholes within the funds themselves as well as compromise their international competitiveness.

By drawing lessons from the regulation of PEIs in the UK, other successful PEI industries and through self-analysis, the South African private equity industry can develop a consolidated and facilitative regulatory framework. This can be based on co-regulation crafted along the lines of the Walker Guidelines (which encourage disclosure and transparency) as well as a consolidated Act to regulate the legal structure of *en commandite* partnerships and deal with wanton and/or unexplained non-compliance. This model of co-regulation has the potential to improve PEIs performance in SA as it combines the benefits of legal certainty with the flexibility and acceptance of co-regulation, making private equity funds attractive to both investors and investee companies. The following recommendations may help SA develop an improved regulatory framework for the private equity industry.

6.2 RECOMMENDATIONS

In general, PEIs are high risk (credit, market and liquidity risks) investments. They usually form ‘a part of the asset allocation of those portfolios that aim to make capital gains through higher

risk and higher return investments.'[414] The huge amounts of capital outlay involved demand supportive regulatory and corporate governance measures. The main reason for 'regulatory intervention is to protect investors from manipulation, promote regulatory responsibilities, and enable a better understanding of the advantages and limitations of investor-owned, privately pooled funds.'[415] In SA there has generally been a shift towards imposing tremendous discipline on the boards of directors of investee companies and managers of funds while the private equity funds themselves often remain opaque and complex. When there is excessive regulation of the private equity industry it can negatively affect capital market efficiency and encourage funds to move to more lightly regulated jurisdictions.[416] On the other hand, too little regulation can also reduce market confidence in the South African capital markets.[417] Therefore the following recommendations are suggested in an effort to strike a balance between excessive control and inadequate regulation with a view to improving market confidence in the private equity industry. The recommendations suggested pertain to the private equity industry guidelines, the B-BBEE Act, regulation of the PEIs, and listing of more PEIs on the JSE.

6.2.1 Industry guidelines

It is recommended that SAVCA, as the industry's regulating body, should set up a soft law framework and industry guidelines that can be compared to those that regulate companies on the JSE. The co-regulatory framework would inform expected behaviour and best practice, as a way of regulating the industry. It would draw from the G20 recommendations,[418] the AIFM Directive, the Dodd-Frank Act in the USA, and the Walker Guidelines in the UK. SAVCA could reinforce the guidelines by actively monitoring and reviewing them regularly. Co-regulation of this nature would be similar to the King Reports on Corporate Governance but would provide codes of best practice that are specific to PEIs. The framework would be specifically tailor-made to address the evolving obligations of the private equity industry especially with regards to disclosing in time the performance of funds and transparent management procedures. If the guidelines can

414 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag* 223.
415 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag* 223.
416 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).
417 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).
418 G20 *G20 Working Group 1 Enhancing Sound Regulation and Strengthening Transparency* (2009).

function along the lines of the Walker Guidelines, they will address such issues as 'the valuation of the funds' investments, detailed financial accounts, communication to all stakeholders of the governance approach and the type of investment in investee firms as well as 'structure' and amount of debt'.[419] The management and shareholders of portfolio companies would also disclose their decision-making powers and loan agreements.[420] As is the case with the Walker Guidelines, GPs would be required to publish annual reviews that are accessible on their websites, which would enable investors to understand more about the activities of PEIs.[421] In addition, PEIs could give a breakdown of management fees or carried interest to SAVCA as the independent oversight body.

6.2.2 Broad-Based Black Economic Empowerment Act (B-BBEE Act) of 2003

The B-BBEE Act 'equity ownership requirements have generally proved challenging for multinational companies in SA with regard to disposing of an equity interest in their local operations.' [422] In recognition of this, there have been exceptions for multinationals, such as, Hewlett Packard, that permit them to 'invest in equity equivalent programmes or dispose of a stake in the offshore parent company.'[423] Ultimately, Hewlett Packard set up the HP Business Institute for the purpose of skills development as an equity equivalent programme. Similarly, in relation to PEIs, more lenient programmes on skills development and ownership structures could strengthen the performance of the industry. While affirmative action is essential, SA has come of age and is able to have management systems that are based on merit and do not only increase investor confidence but are also international competitiveness. A fund manager that fails to establish a favourable track record may consequently fail to attract investors or take part in investment consortiums with other private equity funds. Investment acumen is an essential factor in handling collective funds as the livelihood of ordinary citizens, such as, pensioners depends on it. In addition, a gradual process of identifying broader, barriers to the advancement of the

419 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag* 223.
420 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag* 221.
421 Addleshaw Goddard 'The Walker Guidelines for disclosure and transparency in private equity' available at *http://www.addleshawgoddard.com/asset_store/document/walker_guidelines_-_checklist_95735.pdf* (accessed 25 February 2015).
422 Davids E & Hale A *Mergers and Acquisitions Review* (2012) 4.
423 Davids E & Hale A *Mergers and Acquisitions Review* (2012) 4.

previously disadvantaged groups that also allows skills transfer is required for the industry to remain internationally competitive. According to Anthea Jeffery[424] this would mean that the South African regulators could continuously improve education; free the 'labour market from excessive regulation and end other damaging dirigisme invention to make SA much more attractive to direct investors, both local and foreign.'[425] The sustainable correlation of the PEIs and the B-BBEE objectives is imperative as the impact of the B-BBEE Act is 'arguably more significant in private equity than in the listed company environment.'[426]

6.2.3 Regulation of the private equity legal structure

The *en commandite* partnership is akin to the limited liability partnership used in PEIs internationally and it is essential for SA to maintain this legal structure in order to be in conformity with international standards.[427] Accordingly, there is no real need to amend South Africa's *en commandite* partnerships. However, there is need to develop a regulatory framework to control the activities of the legal structure in the country. Therefore it is suggested that *en commandite* partnerships should be registered with the Registrar of Companies to ensure vital information on all investors is filed with the FSB. The FSB could share vital details only with the relevant authorities in order to ensure that effective oversight is maintained, particularly when a fund is located in a jurisdiction different to that of the manager.[428] The advantage of such regulation is that if the government would decide that a private equity fund has grown too large and is too risky; the fund could be placed under stricter supervision by the FSB.[429]

For all the above mentioned reasons, consolidating the fragmented legislation on PEIs is required in order to regulate *en commandite* partnerships and ultimately all privately pooled funds trading as PEIs and hedge funds in SA. Learning from the Limited Partnerships Act of the UK, the 'new Act' would regulate a number of issues that arise in the financial activities of *en commandite*

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424 Jeffery A 'BEE is flawed and should be scrapped' *Mail and Guardian* 18 January 2013.

425 Jeffery A 'BEE is flawed and should be scrapped' *Mail and Guardian* 18 January 2013.

426 Missankov I, Van Dyk R & Van Biljon M e*t al.* 'Is private equity a suitable investment for South African pension funds?' available at *http://www.itinews.co.za/content/media/companydocs/5f9cc53b-ddf5-4041-8151-2ced3b412681.pdf* (accessed 08 November 2014).

427 Bowman Gilfillan *Private equity Africa yearbook 2013/14 2* ed (2014) 23.

428 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag* 220.

429 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag* 220.

partnerships and ultimately PEIs. It is suggested that 'the Act' should provide for the registration of funds with the FSB so that the relationship between the LPs and the GPs does not just depend on explicit contractual arrangements. At the moment only fund managers are registered and regulated by the FSB, in accordance with the FAIS Act, but it is also essential for the FSB to have a record of investors and to monitor their activities in the funds. The registration statement would be required to be signed by both general and limited[430] partners and submitted to the Registrar of Companies. Details of the names of all of LPs and the capital contributions of the LP would be submitted, and the information would be publicly available at the FSB.[431] This would increase transparency and help potential investors make informed decisions. More importantly, the 'new Act' would provide for the rights and obligations of the partners and require that all LPs be treated equally. The 'new Act' could also codify some common law provisions, such as, a requirement that an investor's capital may not be returned prior to the termination of the *en commandite* partnership. The reporting and disclosure requirements on portfolio companies may also need to be provided for in the regulations. However, transaction information that is sensitive and confidential would only be shared with the regulatory authorities.

An Act regulating *en commandite* partnerships could consolidate all the fragmented regulations of private equity funds that emanate from the common law and legislation, and harmonise these regulatory instruments. These include the FAIS Act,[432] the B-BBEE Act,[433] and the BEE policy framework, the Companies Act,[434] the PFA,[435] the FMA,[436] the Exchange Control Regulations 1961, the Competition Act,[437] the JSE Listing Requirements and the King Reports on Corporate Governance. In addition, the 'new Act' could also incorporate regulations that recognise regional ties and multinational agreements, along the lines of the EU's AIFM Directive. A shift towards a proactive, risk management approach through early intervention and enforcement could also be an important dimension in PEIs regulation.

430 Section 8 UK Limited Partnerships Act 1907.
431 Sections 3, 8 and 9 UK Limited Partnerships Act 1907.
432 Act 37 of 2002.
433 Act 53 of 2003.
434 Act 71 of 2008.
435 Act 24 of 1956.
436 Act 19 of 2012.
437 Act 89 of 1998.

It is recommended that new legislation that regulates *en commandite* partnerships addresses challenges surrounding partnerships in SA particularly as a result of not having a separate legal *persona.* A 'new Act' can provide for litigation, insolvency, value added tax and procedural law with regards to *en commandite* partnerships. *En commandite* partnerships also need clear provisions on the ownership of economic risk to avoid 'costly barriers for lenders when they negotiate settlements.'[438]

6.2.4 Listing private equity funds

It is recommended that private equity firms be listed on the JSE including venture capital funds, buyout funds and development capital funds.[439] The current global trend is that PEIs are in search of more stable capital markets and are increasingly raising funds by listing on 'public markets.' [440] The key benefits of listing are: increased liquidity for investors as they are able to trade their interests on the listed market, and that the fund will have access to investors who prefer to, or are required to, invest only in listed securities. In addition, the listed private equity structures are generally regarded as being less risky as they are subject to greater regulation than unlisted companies. The disadvantages of PEIs being listed include increased public disclosure and the related additional costs. However, it is anticipated that the disadvantages will be outweighed by the benefits mentioned above.

In sum, excessive regulatory measures could be unappealing to both investors and private equity fund managers, and would certainly impede the growth of the private equity market. Co-regulation of PEIs can allow, if well considered, appropriate control of privately pooled funds. In addition, a new consolidated Act for regulating PEI legal structures is required to provide sanctions in those difficult cases where co-regulation falls short legally.

438 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

439 Financial Services Authority Discussion paper 06/06 'Private equity: a discussion of risk and regulatory engagement' (2006) available at *www.fsa.gov.uk/pubs/discussion/dp06_06pdf* (accessed 18 February 2015).

440 McCahery AJ & Vermeulen PME 'Private equity regulation: a comparative analysis' (2012) 16 *J Manag* 220.

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