Private Equity: Significant Regulatory Developments

In recognition of South Africa's economic position in Africa, legislative and policy changes have been adopted by the South Africa government over the period 2010-2011, in order to encourage direct foreign investments including through private equity. The African private equity industry has over the years shown significant growth and resilience when compared to similar industries among emerging and developed markets.

Company law

The South African Companies Act, 2008 came into force on 1 May 2011 (the Companies Act). The Companies Act includes, as one of its purposes, the encouragement of entrepreneurship and enterprise development by: (i) simplifying the procedures for forming companies in South Africa; (ii) reducing the costs associated with the formalities of forming a company and maintaining its existence; and (iii) seeking to promote transparency and higher levels of corporate governance and accountability.

Exchange control regulations

In order to encourage foreign direct investment, exchange control regulations have been cautiously relaxed. Some of the relaxations most significant for the private equity industry were introduced in 2010 and earlier this year. One of the results of these changes is retirement funds and the underwritten policy business of long-term insurers that may now invest up to 25% of the retail assets under their management, whilst retirement funds and the underwritten policy business of long-term insurers may invest up to 35% of the retail assets that they manage. Institutional investors are also allowed to invest an additional 5% of their total retail assets by acquiring foreign denominated portfolio assets in Africa through foreign currency transfers from South Africa or acquiring approved inward listed investments.

In the South African Reserve Bank's (SARB) exchange control circular 2/2011, issued early this year, the SARB announced that qualifying headquarter companies would be treated, for exchange control purposes, as non-resident companies other than for their reporting obligations. The consequence of this announcement is that there is no longer a need for qualifying headquarter companies to obtain the SARB's approval on a deal by deal basis for transactions outside of the common monetary area, and that these qualifying companies now only have to acquire upfront approval for foreign investment and thereafter, to adhere to their reporting obligations as required by the SARB (i.e. provide annual reports on the fund's draw downs and realisations).

Taxation

Amendments to the South African Income Tax Act, 1962 (the ITA), which came into effect at the beginning of this year, have the effect that qualifying headquarter companies will be entitled to tax relief in South Africa. In order for a company to qualify for the proposed tax relief, it must meet the requirements of the definitions of a “headquarter company” set out in the ITA.

On 2 June 2011, the South African Treasury released the Draft Taxation Laws Amendment Bill, 2011 which proposed a moratorium on the use of section 45 of the ITA (which is one of the significant tax provisions relied upon for many restructuring, mergers and acquisitions and private equity transactions), in respect to all disposals made on or after 3 June 2011. The Treasury however, revised its proposal in respect of section 45 after extensive public consultation, which signified the Treasury’s commitment to ensuring that South African investment legislative policies are robust and take into account the investment industries outlook, in order to maintain a facilitative investment climate.

In the revised proposal which is contained in the Taxation Laws Amendment Bill No. 19 of 2011, Treasury seeks to introduce a section that will control the deduction of interest incurred on debt raised or secured to fund the acquisition of assets in term of restructuring transactions, which include intra-group transactions (Section 45), amalgamation transactions (section 44) and liquidation transactions (section 47). The effect of the proposal is that interest associated with debt used to finance a reorganisation transaction or debt that refinances or is substituted for debt that was used to fund a reorganisation will no longer be automatically deductible. Instead, the South African Revenue Service (SARS) may on application by an acquitting company (a transferee company contemplated in section 45(1) or a holding company contemplated in section 47(1) of the Income Tax Act) issue a directive permitting the deduction of the interest. In considering the application for the directive, SARS will take into account the amount of interest incurred by the acquiring company, and the amounts of interest incurred, received or accrued in respect of all debt instruments issued to fund a debt instrument in respect of which interest is incurred by the acquiring company. SARS will only issue the directive if it satisfied, on the basis of criteria set out in regulations passed by the Minister of Finance, that the issuing of the directive will not lead not be likely to lead to s significant reduction of the tax liability of all the parties who incur, receive or accrue interest in respect of the debt dealt with in the section. SARS may issue the directive subject to conditions and limitations.

Amounts (other than interest or dividends) received by the holder of a debt instrument or share (other than an equity share) issued by a company that forms part of the same group of companies as one of the parties to an intra-group transaction and the proceeds of which were used to fund or facilitate an intra-group transaction, will be exempt from tax in certain circumstances. The exemption will only apply to the extent that the amount is applied to settle the outstanding amounts in respect of the debt instrument or shares.

Financial Advisory and Intermediary Services Act (“FAIS Act”)

The Financial Services Board (FSB) published a draft Specific Code of Conduct of Financial Services Providers and Representatives Conducting Financial Services Business with Professional Clients on 9 June 2011 (the Specific Code). In the Specific Code the FSB recognises that certain types of clients do not require the same level of protection as is provided for in the FAIS Act. The FSB has also accepted that financial services providers rendering financial services to "sophisticated" clients would benefit from having the flexibility of operating under a more principle-based rather than rules based code of conduct without negatively impacting on such client's interest. Under the current draft of the Specific Code, a private equity fund may qualify as a "professional client". If the current draft is definition of "professional client" is retained in the Specific Code, the implication will be that the investment advisors to such a private equity fund would only be required to comply with the new code in respect of financial services rendered to the fund and not the general code of conduct.

South Africa's private equity outlook

The legislative reforms introduced during the period 2010-2011 signify the government's recognition of South Africa's economic position in Africa, and its objective to remove what are considered to be significant barriers to South Africa's role as the gateway jurisdiction for private equity funds into the rest of Africa.

With the South African governments continued commitment to reforming investment policies, and Africa's attractive investment opportunities, such as its abundant natural resources, low asset valuations, and largely untapped consumer markets, we see potential for further growth of the South African private equity industry in the coming year. The South African private equity market continues to display on-going resilience and has performed positively than peer sectors abroad. We have recently seen this outlook displayed by proposed investment activities by large private equity funds into South Africa. In line with this view, we have recently advised the Carlyle Group's interest in the South African market by its acquisition bid for the auction of Savcio Holdings (Proprietary) Limited, the introduction of Capital Partners by Eaton Towers as an investor in relation to a equity funding deal, and Pinebridge Gateway Partners' acquisition of a minority stake in Thuthuka Group to name a few.

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