RECENT REGULATORY UPDATES IN SOUTH AFRICA AND THEIR IMPACT ON PRIVATE EQUITY

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The ever-growing reports of deals in South Africa continue to point to investor optimism in the region. However, legislators and regulators in South Africa have recognised that in order to continue this trend, they will need to consider, review and, where appropriate, amend, the existing legal framework. On this basis, this article sets out the recent developments in the South African private equity industry over the last year.

Loop Structures

The most notable development in South Africa over the last few months comes by way of the abolition of the prohibition against loop structures, which took effect from 1 January 2021. Under previous South African exchange control rules, a South African exchange control resident (individual or company) could not invest in a foreign structure that directly or indirectly owned assets in the Common Monetary Area (being South Africa, Eswatini, Lesotho, Namibia and South Africa) where such investments were subsequently invested back into the Common Monetary Area.

With this abolition in place, private equity funds that are tax resident in South Africa (i.e., a South African exchange control resident) may now make investments by way of the loop structure. However, an investment made this way prior to 1 January 2021 is still subject to approval by the Financial Surveillance Department of the South African Reserve Bank.

Private equity funds with authorised foreign assets may invest in South Africa, provided that where South African assets are acquired through a loop structure, the investment must be reported to an Authorised Dealer of the South African Reserve Bank as and when the transaction is finalised, and the private equity fund will be required to provide certain documents to the South African Reserve Bank on an annual basis through its Authorised Dealer.

All investors and funds that are either currently invested in loop structures or who have been unable to make investments as a result of the loop structure restrictions, should carefully consider the impact of the proposed relaxations on their current or future investments, particularly in relation to the potential tax impacts. Certain new tax laws that have been introduced are aimed specifically at these structures, which may result in an increased tax liability in certain scenarios. Further, the capital gains tax exemption that would apply on the disposal of shares in a foreign company will no longer apply to the disposal of shares in a controlled foreign company to the extent that such company's assets consist of South African assets.

Changes to the Pension Funds Act

Under Regulation 28 to the Pension Funds Act 24 of 1956, retirement funds are limited in respect of the percentages of their assets that they may invest in different asset classes. Various industry members, including the Southern African Venture Capital and Private Equity Association (SAVCA), have expressed the view that the current Regulation 28 constrains asset allocation decisions, which could then leave investors with potentially inefficient portfolios.

The proposed changes to Regulation 28, as outlined by the South African Minister of Finance during the national budget speech on 24 February 2021, seem like a welcome proposal to provide pension funds with a higher degree of diversification. The main proposed change includes allowing retirement funds to invest 45% of the funds in South African infrastructure and 10% in African infrastructure outside of South Africa, thereby increasing the maximum infrastructure investment exposure of retirement funds to 55%.

Another proposed change to Regulation 28 seeks to make private equity funds a standalone asset class that is separate to that of an investment in hedge funds. Furthermore, there are proposals to increase the limit of investments that pension funds can make in the private equity funds asset class from 10% to 15%, which of course will assist private equity funds in their various fundraising endeavours.

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Changes to the Income Tax Act

The South African Minister of Finance has also noted the abolition of the venture capital tax incentive present in section 12J of the Income Tax Act 58 of 1962 with effect from 30 June 2021; the rationale being that the incentive had not "sufficiently" achieved its objective of developing small, medium and micro-enterprises (SMMEs) "instead it provided a significant tax deduction to wealthy taxpayers".

Section 12J sought to encourage equity funding to SMMEs by allowing a taxpayer the benefit of a tax deduction in respect of 100% of any expenditure that the taxpayer actually incurred when acquiring shares of a venture capital company. The possible end of the section 12J tax break could have a material impact on the South African venture capital asset class and consequently lead to long-term impacts on certain sectors that depend on this type of funding.

COFI Bill

The Conduct of Financial Institutions (COFI) Bill is another regulatory development on the horizon. The COFI Bill intends to inter alia streamline the conduct requirements for financial institutions, which are currently regulated by a number of separate financial sector laws. The COFI Bill will inter alia replace the conduct provisions in various financial sector laws, with the aim to build a strong, effective and consistent market conduct legislative framework for all institutions that undertake financial activities – with the ultimate aim being putting the client/investor first. Traditional products such as collective investment schemes and private equity funds will also be licensed under the framework of the COFI Bill. This introduces a change to the current position of private equity funds in South Africa in that the unregulated investment class will now be subject to regulatory licensing and oversight by the Financial Sector Conduct Authority.

Compliance with the provisions of COFI – particularly in terms of licensing, application of conduct standards and treating of customers fairly – will become more of a focus point. Financial service providers will need to ensure that, amongst other things, governance practices are aligned with the COFI principles; the most important principle being treating customers fairly, which is an outcome based regulatory and supervisory approach that is aimed at ensuring that financial institutions deliver specific, clearly set out fairness outcomes for financial customers. These include outcomes such as providing customers with clear information before, during, and after the sale and providing products and services of an acceptable standard as expected by the customers.

The second round of comments on the COFI Bill closed on 30 October 2020 and the National Treasury is set to finalise the COFI Bill and thereafter submit it to Cabinet for approval and tabling this year. However, it is unclear at this point in time when exactly the COFI Bill will be enacted.

Broad Based Black Economic Empowerment (B-BBEE) Codes

The B-BBEE Codes, which seek to promote the participation of black people in the South African economy, have had a significant recent impact on the South African private equity industry. Under the B-BBEE Codes, shares held by private equity funds, which meet certain criteria, are deemed to be 100% black-owned. Therefore, a measured entity (such as a portfolio company) can treat any of its ownership arising from a private equity fund as being held by black people if, inter alia, (1) the fund manager is a black-owned company, (2) at least 51% of the private equity fund's executive management and senior management are black people and (3) at least 51% of the profits made by the fund manager post the realisation of any of its investments accrues to black people by written agreement.

When structuring a private equity investment that has B-BBEE ownership requirements, it is not uncommon to use employee share ownership schemes (ESOPs) as part of the investment in the underlying portfolio company in order to hold a percentage of the shares for the benefit of black employees. This might be part of or separate to any structuring considerations regarding the 'carry interest' applicable for the management of the fund manager and/or the general partner. A practice note published by the South African Minister of Trade, Industry and Competition on 18 May 2021 has clarified a few points on the interpretation of the B-BBEE Codes specific to ESOPs, including inter alia that ownership points can be derived from the shareholdings of broad-based vehicles such as ESOPs rather than from the beneficiaries of an ESOP.

A study conducted by SAVCA in 2020 indicated that private equity investments were effective in growing company revenue as the number of companies categorized as exempt microenterprises (i.e., businesses whose revenues are R10 million (or £500,000) or lower) after a private equity investment decreased from 26% to 13% while the number of companies categorised as generic microenterprises (i.e., businesses whose revenues exceed R50 million (or £2.5 million)) after a private equity investment increased from 51% to 66%.

Furthermore, private equity/venture capital investments played a role in improving the B-BBEE scores of companies with lower initial ratings, while also significantly improving the B-BBEE scores of companies with higher ratings. These results were effectively a strong showing of the advantages of private equity investments in the South African market.

The Impact of LPA Models

The Institutional Limited Partners Association (ILPA) has put together two Model Limited Partnership Agreements (the ILPA LPAs), being two Delaware-law based comprehensive limited partnership agreements (one dealing with deal-by-deal carry arrangements and one dealing with life of fund carry arrangements). The ILPA LPAs essentially set out ILPA's views as to what international limited partners should seek in the negotiations around the formation of funds. The ILPA LPAs were last updated in 2020.

The ILPA LPAs are predominately limited partner friendly and contain a whole host of provisions not appropriate in the South African and broader African market. For example, the inclusion of the option to impose a haircut on the general partner's carried interest upon the vote of a supermajority of limited partners. This brings forth an interesting dynamic when dealing with international investors that are more used to having certain of these provisions. Even though it leads to more intentional discussions around provisions historically considered 'market', it has not hindered fundraising in South Africa.

Similarly, there has been increased interest in the model limited partnership agreement (EDFI LPA) prepared by The European Development Finance Institutions (EDFI), which is anticipated to be used when establishing private equity funds targeting development finance institutions (DFI) is expected that the use of the EDFI LPA will appeal to DFI investors, which in turn could streamline the process of closing out DFI investments in South Africa.

Conclusion

The recent mixed bag of regulatory changes in South Africa have seemingly balanced out, if not led to improvements in, the overall effect to the private equity industry in South Africa. Looking towards a post-pandemic future, in an effort to increase investments in South Africa, one may expect to see further changes in the regulatory landscape, initiatives and approaches that would renew and/or strengthen the interest in the South African private equity industry.

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